Department of the Treasury

Internal Revenue Service

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Retirement Plans for Small Business

(SEP, Keogh, and SIMPLE Plans)

For use in preparing

1997 Returns

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Important Changes for 1997

SIMPLE retirement plans. Beginning in 1997, you may be able to set up a savings incentive match plan for employees (SIMPLE). Generally, you can set up a SIMPLE plan if you have 100 or fewer employees and meet other requirements. See *SIMPLE Plans* after the *Simplified Employee Pension (SEP)* discussion.

Repeal of salary reduction arrangement under a SEP (SARSEP). Beginning in January 1997, an employer is no longer allowed to establish a salary reduction simplified employee pension (SARSEP) plan. However, participants (including new participants) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. New participants include employees of the employer hired after 1996. See *Salary Reduction Arrangement* under *Simplified Employee Pension (SEP).*

Minimum required distribution rule modified. Beginning in 1997, new law changes the required beginning date used to figure the minimum required distribution from qualified retirement plans. The required beginning date for most participants still employed after age 70½ is April 1 of the calendar year that follows the calendar year in which they retire. For years prior to 1997, participants in qualified plans and IRAs were required to begin distributions by April 1 of the year following the calendar year in which they reach age 70½, whether or not they had retired. The new law does not apply to IRAs. For more information on the minimum distribution rules, see *Required Distributions* under *Distributions* in the *Keogh Plans* section.

Repeal of 15% additional tax on excess distributions and excess retirement accumulation. If you receive retirement distributions from a qualified retirement plan after December 31, 1996, you are no longer subject to the additional 15% excise tax on excess distributions. New law also repeals the additional 15% tax on excess retirement accumulations for taxpayers who died after December 31, 1996.

Aggregation rules repealed. Beginning in 1997, the special aggregation rules that only apply to self-employed individuals are eliminated.

New definition of "leased employee." Beginning in January 1997, the definition of "leased employee" has changed. See *Keogh Plan Qualification Rules,* for more information.

New definition of highly compensated employee. Beginning in January 1997, the definition of highly compensated employee has changed. See *Definitions* under *Simplified Employee Pension (SEP).*

Waiver of minimum waiting period for joint and survivor annuities. For plan years beginning after 1996, a plan participant may elect to waive (with spousal consent) the 30–day election period if the retirement distribution begins more than 7 days after a written explanation of the qualified joint and survivor annuity is provided. For more information, see *Survivor benefits,* near the end of the publication.

Important Changes for 1998

Participant's compensation. Under current law, the limits on contributions to a defined contribution plan cannot exceed the smaller of $30,000 or 25% of the compensation actually paid the participant. New law, which takes into account amounts deferred in certain employee benefit plans, will increase the tax-deferred amount that may be contributed by the employer at the election of the employee for years beginning after December 1997. The deferrals include amounts contributed by an employee under a:

1) Qualified cash or deferred arrangement (section 401(k) plan),
2) Salary reduction agreement to contribute to a tax-sheltered annuity (section 403(b) plan), a SIMPLE IRA plan or a SARSEP,
3) Section 457 nonqualified deferred compensation plan, and
4) Section 125 cafeteria plan.

The limits on elective deferrals is discussed later under *Salary Reduction Arrangement* and in the Keogh Plan section.

401(k) matching contributions for self-employed. Beginning in 1998, matching contributions to a 401(k) plan on behalf of a self-employed individual will no longer be treated as elective contributions subject to the limit on elective deferrals. The matching contributions for partners and other self-employed individuals will receive the same treatment as the matching contributions of other employees. For more information, see *Limit on Elective Deferrals* under *Keogh Plans.*

Important Reminder

Plan amendments required by changes in the law. If your Keogh plan needs to be revised to conform to recent legislation, you may choose to get a determination letter from your IRS key district office approving the revision. Generally, master and prototype plans (but not the elections in their related adoption agreements) are amended by sponsoring organizations. However, there are instances when you may need to request a determination letter regarding a master or prototype plan that is a nonstandardized plan and that you maintain. Your request should be made on the appropriate form (generally Form 5300 or 5307 for a master or prototype plan) and should be filed with Form 8717, *User Fee for Employee Plan Determination Letter Request,* and the appropriate user fee.

You may have to amend your plan to comply with tax law changes made by the Small Business Job Protection Act of 1996, Public Law 104–188; the Uruguay Round Agreements Act, Public Law 103–465; and the Taxpayer Relief Act of 1997, Public Law 105–34. You need to make these amendments before the last day of the first plan year beginning after 1998.

Transition relief. IRS has issued guidance and transition relief for qualified plans that fail to make a minimum required distribution to an employee (other than a 5% owner) who reached age 70½ in 1996 and had not retired by the end of 1996. The relief is for plans that were not amended to comply with the recent change in the definition of the *Required beginning date* (discussed under *Distributions* in the Keogh section). The transition relief is explained in Announcement 97–70 (published on page 14 of Internal Revenue Bulletin 97–29).

For further information, contact employee plans taxpayer assistance telephone service between the hours of 1:30 p.m. and 3:30 p.m. Eastern Time, Monday through Thursday, at (202) 622–6074/6075. (These are not toll-free numbers.)

Introduction

This publication discusses retirement plans that the owner of a small business, including a self-employed person, can set up and maintain for employees. It gives the information on the following types of retirement plans.

- Simplified Employee Pension (SEP) plans,
- SIMPLE plans, and
- Keogh plans (also called H.R. 10 plans).

Note that the plans described under *Keogh Plans* can also be established and maintained by employers that are corporations, and all the rules in that section apply to corporations, except where specifically limited to the self-employed.

What is covered in this publication. This publication can help a small business owner set up the type of retirement plan that best suits his or her needs. Topics covered include contribution and deduction limits, reporting and disclosure requirements, definitions, and qualification rules. The key rules for SEP, SIMPLE, and Keogh retirement plans are outlined in Table 1, under *Keogh Plans.*

Major features of retirement plans. The major features (including the similarities and differences) of SEP, SIMPLE, and Keogh plans are discussed next.

Under a SEP plan, contributions are made to individual retirement arrangements (SEP-IRAs) set up for all employees who qualify. A SEP can be set up by a self-employed individual (considered both an employer and employee), a partnership, or a corporation.

Beginning in 1997, a **SIMPLE plan** can be set up by any small employer (including

corporations and self-employed individuals). The discussion of *SIMPLE Plans* follows the *Simplified Employee Pension (SEP)* section.

Only a sole proprietor or a partnership can set up **a Keogh plan.** The plan must meet certain legal requirements to qualify for tax benefits. See *Setting Up a Keogh Plan,* later, for a discussion of a standard form of plan that generally meets these requirements, and that you can adopt through a sponsoring organization.

Certain fishermen are considered to be self-employed for purposes of setting up a Keogh plan. (See *Fishermen treated as self-employed* in the glossary near the end of this publication.)

There is an example near the end of the Keogh plan discussion showing you how to complete and file the Form 5500–EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan.* See *Reporting Requirements,* later, to determine if you must file this annual return.

Topics not covered in this publication. This publication focuses on the needs of the small employer. Therefore, it does not cover all the rules that may be of interest to employees. Publication 590 contains a comprehensive discussion of the special IRA rules that an employee needs to know. Publication 575 covers the tax treatment of distributions from a qualified plan, including the tax treatment of rollovers and special averaging.

Useful Items

You may want to see:

Publications

- ☐ **535** Business Expenses
- ☐ **575** Pension and Annuity Income
- ☐ **553** Highlights of 1997 Tax Changes
- ☐ **590** Individual Retirement Arrangements (IRAs) (Including SEP-IRAs and SIMPLE IRAs)

Forms (and Instructions)

- ☐ **1099–R** Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- ☐ **5304–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (Not Subject to the Designated Financial Institution Rules)
- ☐ **5305–SEP** Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- ☐ **5305A–SEP** Salary Reduction and Other Elective Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement
- ☐ **5305–SIMPLE** Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) (for Use With a Designated Financial Institution)
- ☐ **5329** Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, Modified Endowment Contracts, and MSAs
- ☐ **5330** Return of Excise Taxes Related to Employee Benefit Plans
- ☐ **5500–C/R** Return/Report of Employee Benefit Plan (With fewer than 100 participants)
- ☐ **5500–EZ** Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

Help from IRS. See *How To Get More Information,* near the end of this publication for information about getting these publications and forms.

Note: All references to "section" in the following discussions are to sections of the Internal Revenue Code, unless otherwise indicated.

Tax Benefits of SEP, Keogh, and SIMPLE Plans

Terms you may need to know (see Glossary):

Common-law employee
Contribution
Deduction
Employee
Self-employed individual
Sole proprietor

A deduction for contributions to a retirement plan and deferral of tax on income of the plan are benefits that apply to a small employer, including a *self-employed individual* (see *Glossary*) who has a SEP, a Keogh or a SIMPLE plan.

If you are self-employed, you can take an income tax deduction for certain contributions you make for yourself to the plan. You can also deduct trustee's fees if contributions to the plan do not cover them. Deductible contributions plus the plan's earnings on them stay tax free until you receive distributions from the plan in later years. If you are a *sole proprietor,* you can deduct contributions you make for your *common-law employees* (see *Glossary*) as well as contributions you make for yourself. A common-law employee cannot deduct contributions you make.

Simplified Employee Pension (SEP)

Terms you may need to know (see Glossary):

Annual addition
Annual benefit
Business
Common-law employee
Compensation
Contribution
Deduction
Earned income
Employee
Employer
Partner
Self-employed individual
Sole proprietor

A simplified employee pension (SEP) is a written plan that allows you to make contributions toward your own (if you are a self-employed individual) and your employees' retirement without getting involved in the more complex Keogh plan. But some advantages available to Keogh plans, such as the special tax treatment that may apply to Keogh plan lump-sum distributions, do not apply to SEPs.

Under a SEP, you make the contributions to an individual retirement arrangement (called a SEP-IRA in this publication), which is owned by you or one of your common-law employees.

SEP-IRAs are set up for, at a minimum, each *qualifying employee* (defined below). A SEP-IRA may have to be set up for a *leased employee* (defined below), but need not be set up for *excludable employees* (defined below). If the employee cannot be located or is unwilling to execute the necessary set-up documents (SEP agreement and IRA trust), you can execute them for him or her.

Form 5305–SEP. You may be able to use Form 5305–SEP (see reproduction) in setting up your SEP.

This form ***cannot*** be used by an employer who:

- Currently maintains any other qualified retirement plan. This does not prevent you from maintaining another SEP.
- Has maintained in the past a defined benefit plan (defined later under *Keogh Plans),* even if now terminated.
- Has any eligible employees for whom IRAs have not been established.
- Uses the services of *leased employees* (as described later).
- Is a member of an affiliated service group (as described in section 414(m) of the Internal Revenue Code), a controlled group of corporations (as described in section 414(b)), or trades or businesses under common control (as described in section 414(c)), unless all eligible employees of all the members of these groups, trades, or businesses participate under the SEP.
- Does not pay the cost of the SEP contributions.

Do not use Form 5305–SEP for a SEP that provides for employee-elected contributions made under a salary reduction agreement. Use Form 5305A–SEP, or a nonmodel SEP if you permit elective deferrals to a SEP.

SEPs permitting elective deferrals cannot be established after 1996.

Many financial institutions will assist you in setting up a SEP.

You can set up and contribute to a SEP-IRA for a year as late as the due date (plus extensions) of your income tax return for that year. Contributions must be in the form of money (cash, check, or money order). You cannot contribute property. However, you may be able to transfer or roll over certain property from one retirement plan to another. See Publication 590 for more information about rollovers.

You do not have to make contributions every year. But if you make contributions, they must be based on a written allocation formula and must not discriminate in favor of

Form **5305-SEP**
(Rev. January 1997)
Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499

DO NOT File With the Internal Revenue Service

____ makes the following agreement under section 408(k) of the
(Name of employer)

Internal Revenue Code and the instructions to this form.

Article I—Eligibility Requirements (Check appropriate boxes—see **Instructions.**)

The employer agrees to provide for discretionary contributions in each calendar year to the individual retirement account or individual retirement annuity (IRA) of all employees who are at least ________ years old (not to exceed 21 years old) and have performed services for the employer in at least ________ years (not to exceed 3 years) of the immediately preceding 5 years. This simplified employee pension (SEP) ☐ includes ☐ does not include employees covered under a collective bargaining agreement, ☐ includes ☐ does not include certain nonresident aliens, and ☐ includes ☐ does not include employees whose total compensation during the year is less than $400*.

Article II—SEP Requirements (See **Instructions.**)

The employer agrees that contributions made on behalf of each eligible employee will be:

A. Based only on the first $160,000* of compensation.
B. Made in an amount that is the same percentage of compensation for every employee.
C. Limited annually to the smaller of $30,000* **or** 15% of compensation.
D. Paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

________________________________ ________________________________
Employer's signature and date — Name and title

highly compensated employees (defined below). When you contribute, you must contribute to the SEP-IRAs of all qualifying employees who actually performed personal services during the year for which the contributions are made, even employees who die or terminate employment before the contributions are made.

The contributions you make under a SEP are treated as if made to a qualified pension, stock bonus, profit-sharing, or annuity plan. Consequently, contributions are deductible within limits, as discussed later, and generally are not taxable to the plan participants. Contributions generally are not subject to federal income, social security, Medicare, or unemployment taxes.

Partnership. A partnership can have a SEP.

Definitions

The term *self-employed individual* is defined in the glossary. For SEP purposes, a self-employed individual is an employee as well as an employer. A self-employed individual can have a SEP-IRA.

Qualifying employee. This is an individual who has:

1) Reached the age of 21 years,
2) Worked for you in at least 3 of the immediately preceding 5 years, and
3) Received at least $400 in compensation from you for 1997.

Note. You can establish less restrictive participation requirements for employees than those listed, but not more restrictive ones.

Leased employees. If you have leased employees who are treated as your employees and meet the above participation requirements, you must include these employees in your SEP. You have a leased employee who must be treated as your employee if a person who is not your employee is hired by a leasing organization and provides employee services to you under your primary direction or control. These services must be provided by that person on a substantially full-time basis for at least a year under an agreement between you and the leasing organization.

Excludable employees. The following employees need not be covered under a SEP:

1) Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and you, and
2) Nonresident alien employees who have no U.S.-source earned income from you.

Highly compensated employees. For 1997, a highly compensated employee is one who:

- Owned more than 5% of the capital or profits interest in the employer at any time during 1996 or 1997, or
- For 1996, received compensation from the employer of more than $80,000 and, if the employer so elects, was in the top 20% of employees when ranked by compensation.

Contribution Limits

Contributions you make for a year to a common-law employee's SEP-IRA cannot be more than the smaller of 15% of the employee's *compensation* (see *Glossary*) or $30,000. Compensation, for this purpose, generally does not include employer contributions to the SEP. However, if you have a salary reduction arrangement, discussed later, see *Employee compensation defined* under *Salary Reduction Arrangement.*

Annual compensation limit. You generally cannot consider the part of compensation of an employee that is over $160,000 when figuring your contributions limit for that employee. The maximum contribution amount for you or for employees for which the $160,000 limit applies is $24,000.

More than one plan. If you contribute to a defined contribution plan (defined later under *Keogh Plans*), annual additions are limited to the lesser of (1) $30,000 or (2) 25% of the participant's compensation. When you figure these limits, your contributions to all defined contribution plans must be added. Since a SEP is considered a defined contribution plan for purposes of these limits, your contributions to a SEP must be added to your contributions to other defined contribution plans.

Reporting on Form W–2. Do not include SEP contributions on Form W–2, *Wage and Tax Statement,* unless there are contributions over the limit that applies or there are contributions under a salary reduction arrangement as discussed later.

Contributions for yourself. The annual limits on your contributions to a common-law employee's SEP-IRA also apply to contributions you make to your own SEP-IRA. However, special rules apply when figuring your maximum deductible contribution. Also see *Deduction of Contributions for Self–Employed,* later.

Tax treatment of excess contributions. If the amount you contribute to an employee's SEP-IRA (or to your own SEP-IRA) for a year exceeds the smaller of:

- 15% of the employee's compensation (or, for you, 13.0435% of your net earnings from self-employment) or
- $30,000,

the excess is included in the employee's income for the year and is treated as a contribution by the employee to his or her SEP-IRA.

As a result, the annual limit on contributions an employee can make to an IRA (generally, the smaller of $2,000 or the employee's compensation), which also applies to the employee's own contributions to a SEP-IRA, may have been exceeded. In that case, the employee would be subject to a 6% excise tax on the excess unless the employee withdraws it (and any net income earned on the excess) by the due date (including extensions) for filing his or her income tax return for that year and did not take a deduction for the excess.

The employee's IRA deduction may be limited because of coverage by an employer plan (including the SEP), as explained in Publication 590.

When To Deduct Contributions

When you (the employer) can deduct contributions made for a year depends on the tax year on which the SEP is maintained. If the SEP is maintained on a calendar year basis, you can deduct contributions made for a year on your tax return for the year ending with or within that calendar year. If your taxable year is not the calendar year (fiscal year or short tax year) and the SEP is maintained on the basis of that other tax year, you can deduct contributions made for a year on your tax return for that tax year.

When contributions are considered made. Treat any contributions you make on account of a taxable year as made for that year if you make them by the due date (plus extensions) of your income tax return for that year.

Deduction Limits

The most you can deduct for employer contributions for common-law employees is 15% of the *compensation* (see *Glossary*) paid to them during the year from the business that has the plan.

Deduction of Contributions for Self-Employed

When figuring the deduction for employer contributions made to your own SEP-IRA, *compensation* is your *net earnings from self-employment* (see *Glossary*), which takes into account:

1) The deduction allowed to you for one-half of the self-employment tax, and
2) The deduction for contributions on behalf of yourself to the plan.

The deduction for contributions on your behalf and your compensation (net earnings) are dependent on each other. For this reason, the deduction for contributions on your behalf is determined indirectly by reducing the contribution rate called for in your plan. This is done by using the *Rate Table for Self-Employed* (next) or by using the *Rate Worksheet for Self-Employed,* later.

Rate table for self-employed. If your plan's contribution rate for allocating employer contributions to employees is a whole number (for example, 12% rather than 12½%), you can use the following table to find the rate that applies to you. Otherwise, you can figure your rate using the worksheet provided later.

First find your plan contribution rate (the contributions rate stated in your plan) in Column A of the table. Then read across to the rate under Column B. This is the rate to be applied for you as shown in *Example 1,* later.

Rate Table for Self-Employed

Column A If the Plan Contribution Allocation Rate is: (shown as a %)	Column B Your Rate is: (shown as a decimal)
1	.009901
2	.019608
3	.029126
4	.038462
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569
10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15*	.130435*
16	.137931
17	.145299
18	.152542
19	.159664
20	.166667
21	.173554
22	.180328
23	.186992
24	.193548
25	.200000

*The deduction for annual employer contributions to a SEP or profit-sharing plan cannot exceed 13.0435% of your compensation (figured without deducting contributions for yourself) from the business that has the plan.

The rates in the above table and the worksheets that follow apply only to unincorporated employers who have only one defined contribution plan, such as a profit-sharing plan. A SEP is treated as a profit-sharing plan.

Example 1. You are a sole proprietor and have employees. If your plan's contribution rate for allocating contributions is 10% of a participant's compensation, your rate is 0.090909. Enter this rate in step 1 under *Figuring your deduction,* later.

Rate worksheet for self-employed. If your plan's contribution rate is not a whole number (for example, 10½%), you cannot use the *Rate Table for Self-Employed.* Use the *Rate Worksheet for Self-Employed*, next.

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	______
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	______
3) Self-employed rate as a decimal (divide line 1 by line 2)	______

Figuring your deduction. Now that you have your self-employed rate, you can figure your maximum deduction for contributions for yourself by completing the following steps:

Deduction Worksheet for Self-Employed

Step 1 Enter your rate from the *Rate Table for Self-Employed* or *Rate Worksheet for Self-Employed*	______
Step 2 Enter your net earnings from line 3, Schedule C–EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K–1 (Form 1065)	$ ______
Step 3 Enter your deduction for self-employment tax from line 26, Form 1040	$ ______
Step 4 Subtract step 3 from step 2 and enter the result	$ ______
Step 5 Multiply step 4 by step 1 and enter the result	$ ______
Step 6 Multiply $160,000 by your plan contribution rate. Enter the result but not more than $30,000	$ ______
Step 7 Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 28, Form 1040	$ ______

Example 2. You are a sole proprietor and have employees. The terms of your plan provide that you contribute 10½% (.105) of your compensation, and 10½% of your common-law employees' compensation. Your net earnings from line 31, Schedule C (Form 1040) are $200,000. In figuring this amount, you deducted your common-law employees' compensation of $100,000 and contributions for them of $10,500 (10½% x $100,000). This net earnings amount is now reduced to $193,267 because you subtracted your self-employment tax deduction of $6,733. See how to figure the deduction for one-half of your self-employment tax in the reproduction of filled-in portions of both Schedule SE (Form 1040) and Form 1040. You figure your self-employed rate and maximum deduction for employer contributions on behalf of yourself as follows:

Rate Worksheet for Self-Employed

1) Plan contribution rate as a decimal (for example, 10½% would be 0.105)	0.105
2) Rate in line 1 plus one (for example, 0.105 plus one would be 1.105)	1.105
3) Self-employed rate as a decimal (divide line 1 by line 2)	0.0950

Deduction Worksheet for Self-Employed

Step 1 Enter your rate from the *Rate Table for Self-Employed* or *Rate Worksheet for Self-Employed*	0.0950
Step 2 Enter your net earnings from line 3, Schedule C–EZ (Form 1040), line 31, Schedule C (Form 1040), line 36, Schedule F (Form 1040), or line 15a, Schedule K–1 (Form 1065)	$ 200,000
Step 3 Enter your deduction for self-employment tax from line 26, Form 1040	$ 6,733
Step 4 Subtract step 3 from step 2 and enter the result	$ 193,267
Step 5 Multiply step 4 by step 1 and enter the result	$ 18,360
Step 6 Multiply $160,000 by your plan contribution rate. Enter the result but not more than $30,000	$ 16,800

Portion of Schedule SE (Form 1040)

Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	200,000
3	Combine lines 1 and 2	3	200,000
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ▶	4	184,700
5	**Self-employment tax.** If the amount on line 4 is: • $65,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 47.** • More than $65,400, multiply line 4 by 2.9% (.029). Then, add $8,109.60 to the result. Enter the total here and on **Form 1040, line 47.**	5	13,466
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 26** — 6: 6,733		

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1997**

Portion of Form 1040

Adjusted Gross Income

If line 32 is under $29,290 (under $9,770 if a child did not live with you), see EIC inst. on page 21.

23	IRA deduction (see page 16)	23			
24	Medical savings account deduction. Attach Form 8853	24			
25	Moving expenses. Attach Form 3903 or 3903-F	25			
26	One-half of self-employment tax. Attach Schedule SE	26	6,733		
27	Self-employed health insurance deduction (see page 17)	27			
28	Keogh and self-employed SEP and SIMPLE plans	28	16,800		
29	Penalty on early withdrawal of savings	29			
30a	Alimony paid **b** Recipient's SSN ▶	30a			
31	Add lines 23 through 30a			31	23,533
32	Subtract line 31 from line 22. This is your **adjusted gross income** ▶			32	

Step 7
Enter the smaller of step 5 or step 6. This is your ***maximum deductible contribution.*** Enter your deduction on line 28, Form 1040. .... $ 16,800

Multiple Plan Limits

For purposes of the deduction limits, treat all of your qualified *defined contribution plans* (defined later) as a single plan, and treat all of your qualified *defined benefit plans* (defined later) as a single plan. If you have both kinds of plans, a SEP is treated as a separate profit-sharing (defined contribution) plan. A "qualified" plan is a plan that meets certain requirements. See *Keogh Plan Qualification Rules,* later.

SEP and profit-sharing plans. If you also contributed to a qualified profit-sharing plan, you must reduce the 15% deduction limit for that profit-sharing plan by the allowable deduction for contributions to the SEP-IRAs of those participating in both the SEP plan and the profit-sharing plan.

Defined contribution and defined benefit plans. If you contribute to one or more defined contribution plans (including a SEP) and one or more defined benefit plans, special deduction limits may apply. For more information about the special deduction limits, see *Deducting contributions to combination of plans* under *Keogh Plans,* later.

Carryover of excess contributions. If you made contributions in excess of the deduction limit (nondeductible contributions), you can carry over and deduct the excess in later years. However, the excess contributions carryover, when combined with the contribution for the later year, cannot exceed the deduction limit for that year.

Excise tax. If you made nondeductible (excess) contributions to a SEP, you may be subject to a 10% excise tax. To figure and report the excise tax, see *Excise Tax for Nondeductible (Excess) Contributions* and *Carryover of Excess Contributions* under *Keogh Plans,* later.

Where To Deduct on Form 1040

Deduct contributions for yourself on line 28 of Form 1040. You deduct contributions for your common-law employees on Schedule C (Form 1040), on Schedule F (Form 1040), or on Form 1065, whichever applies to you.

If you are a partner, the partnership passes its deduction to you for the contributions it made for you. The partnership will report these contributions on Schedule K–1 (Form 1065). You deduct them by entering the amount on line 28 of Form 1040.

Salary Reduction Arrangement

A SEP established before 1997 can include a salary reduction arrangement. Under this arrangement, your employees can elect to have you contribute part of their pay to their SEP-IRAs. The income tax on the part contributed is deferred. This choice is called an elective deferral, which remains tax free until distributed (withdrawn). This type of SEP is called a salary reduction simplified employee pension (SARSEP). You may be able to use Form 5305A–SEP to maintain this type of SEP. Many qualified financial institutions can assist you in setting up this type of arrangement.

*An employer is not allowed to establish a SARSEP **after 1996.** However, participants (including employees hired after 1996) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan. A new SIMPLE retirement plan (discussed later) is now available to small employers.*

Restrictions. This salary reduction arrangement (elective deferrals) is available only if:

1) At least 50% of your employees eligible

to participate choose the salary reduction arrangement,

2) You have 25 or fewer employees who were eligible to participate in the SEP (or would have been eligible to participate if you had maintained a SEP) at any time during the preceding year, and

3) The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) is not more than 125% of the average deferral percentage (ADP) of all employees (other than highly compensated employees) eligible to participate (the ADP test).

Deferral percentage. The deferral percentage for an employee for a year is the ratio of:

- the amount of elective employer contributions paid to the SEP for the employee for the year, to
- the employee's compensation (no more than $160,000).

A salary reduction arrangement is not available for a SEP maintained by a state or local government or any of their political subdivisions, agencies, or instrumentalities, or a tax-exempt organization.

Limits on elective deferrals. The most compensation a participant can elect to defer for the calendar year 1997 is the smaller of:

- 15% of the participant's compensation, or
- $9,500.

If the employee also participates in a tax-sheltered annuity plan (section 403(b) plan), total deferrals cannot exceed $9,500.

Employee compensation defined. To figure the elective deferral amount for an employee who participates in your salary reduction arrangement, compensation is generally the amount you pay to the employee for the year minus the elective deferral amount (not includible in the employee's income for that year). However, you can choose to treat the deferrals as compensation, as discussed later.

The deferral amount and the compensation (minus the deferral) are each dependent on the other. For this reason, the deferral amount is figured indirectly by reducing the contribution rate for deferrals called for under the salary reduction arrangement. This method is the same one that you, as a self-employed person, use to figure the contributions you make on your own behalf to your SEP-IRA. See *Deduction of Contributions for Self-Employed,* earlier.

For example, if the deferral contribution rate called for under the salary reduction arrangement is 15% of your employee's salary for the year, you figure the deferral amount by multiplying the salary by 13.0435%, the reduced rate equivalent of 15%. See *Rate Table for Self-Employed,* earlier.

Election to treat deferrals as compensation. You, as the employer, can choose to treat elective deferrals for a year as compensation under your salary reduction arrangement, even though the deferrals are not includible in the income of your employees for that year. This method may be used for purposes of calculating deferral percentages for the ADP test. However, the reduced rate method must always be used to determine the maximum deductible contribution (13.0435% of unreduced compensation).

For years beginning after December 1997, a participant's compensation for determining the maximum deductible limit will include certain elective deferrals. This new definition results in an increase in the maximum tax-deferred amount that can be contributed by the employer at the election of the employee.

Alternative definitions of compensation. In addition to the general definition of compensation and the election described in the preceding paragraphs, you can use any definition of compensation that:

- Is reasonable,
- Is not designed to favor highly compensated employees, and
- Provides that the average percentage of total compensation used for highly compensated employees as a group for the year is not more than minimally higher than the average percentage of total compensation used for all other employees as a group.

Self-employed individuals. If you are self-employed (a sole proprietor or a partner), ***compensation*** is your net earnings from your trade or business (provided your personal services are a material income-producing factor), taking into account your deduction for contributions on your behalf to employer retirement plans and the deduction allowed for one-half of your self-employment tax. To figure the amount of the elective deferral contributions made to your own SEP-IRA, see *Deduction of Contributions for Self-Employed,* earlier.

Compensation for this purpose does not include tax-free items (or deductions related to them) other than foreign earned income and housing cost amounts.

Disabled participants. You may be able to elect to use special rules to determine compensation for a participant who is permanently and totally disabled. See Internal Revenue Code section 415(c)(3)(C), which provides that the participant's compensation means the compensation the participant would have received if paid at the rate of compensation paid before becoming permanently and totally disabled.

Tax treatment of deferrals. You can deduct your deferrals that, when added to your other SEP contributions, are not more than the limits under *Deduction Limits,* earlier. Deferrals not more than the average deferral percentage (ADP) test limit (see item 3 under *Restrictions* above) under an elective deferral arrangement are excluded from the employee's wages subject to federal income tax in the year of deferral. However, these deferrals are included in wages for social security, Medicare, and federal unemployment (FUTA) tax purposes.

Reporting on Form W–2. Any SEP contributions relating to your employee's wages under a salary reduction arrangement are included in the Form W–2 wages for social security and Medicare tax purposes only.

Example. Jim's salary reduction arrangement calls for a deferral contribution rate of 10% of his salary. Jim's salary for the year is $30,000 (before reduction for the deferral). The employer did not elect to treat deferrals as compensation under the arrangement. To figure the deferral amount, the employer multiplies Jim's salary of $30,000 by 9.0909% (the reduced rate equivalent of 10%) to get the deferral amount of $2,727.27. (This method is the same one that you, as a self-employed person, use to figure the contributions you make on your own behalf.) See *Rate Table for Self Employed,* earlier.

On Jim's Form W-2, the employer shows total wages of $27,272.73 ($30,000 minus $2,727.27), social security wages of $30,000, and Medicare wages of $30,000. Jim reports $27,272.73 as wages on his individual income tax return.

If the employer elects to treat deferrals as compensation under the salary reduction arrangement, Jim's deferral amount would be $3,000 ($30,000 x 10%) because, in this case, the employer uses the rate called for under the arrangement (not the reduced rate) to figure the deferral and the ADP test. On Jim's Form W-2, the employer shows total wages of $27,000 ($30,000 minus $3,000), social security wages of $30,000, and Medicare wages of $30,000. Jim reports $27,000 as wages on his return.

In either case, the maximum deductible contribution would be $3,913.05 ($30,000 x 13.0435%).

Excess deferrals. The treatment of excess deferrals made under a SARSEP plan is similar to the treatment of excess deferrals made under a Keogh plan. See *Treatment of Excess Deferrals* under *Keogh Plans,* later.

Overall Limits on SEP Contributions

Contributions you make to a common-law employee's SEP-IRA, including elective deferrals, are subject to the SEP limits discussed earlier. These limits also apply to contributions you make to your own SEP-IRA. See *Contribution Limits,* earlier.

Distributions (Withdrawals)

As an employer, you cannot prohibit distributions from a SEP-IRA. Also, you cannot condition your contributions on any part of them being kept in the account.

Distributions are subject to IRA rules. For information about IRA rules, including the tax treatment of distributions, rollovers, required distributions, and income tax withholding, see Publication 590.

Additional Taxes

Additional taxes may apply to a SEP-IRA because of premature distributions, excess accumulations, or excess contributions. For information about these taxes, see chapter 6, *What Acts Result in Penalties?,* in Publication 590. Also, a SEP-IRA account may be disqualified, or an excise tax may apply, if the account is involved in a prohibited transaction, discussed next.

Prohibited transaction. If an owner improperly uses his or her SEP-IRA, such as by borrowing money from it, the owner has engaged in a prohibited transaction. In that case, the SEP-IRA will no longer qualify as an IRA. For a list of prohibited transactions, see *Prohibited Transactions* under *Keogh Plans,* later.

Effect on owner. If a SEP-IRA is disqualified because of a prohibited transaction, the assets in the account will be treated as having been distributed to the owner of that SEP-IRA on the first day of the year in which the transaction occurred. The owner must include in income the excess of the assets' fair market value (on the first day of the year) over any cost basis in the account. Also, the owner may have to pay the additional tax on premature distributions. For more information, see *Tax on Prohibited Transactions* under *Keogh Plans.*

Reporting and Disclosure Requirements

If you set up a SEP using **Form 5305–SEP,** or **Form 5305A–SEP,** you can satisfy the Internal Revenue Code reporting and disclosure requirements by giving each employee a copy of the completed agreement form (including its instructions) and a statement each year showing any contributions to the employee's SEP-IRA. If you set up a salary reduction SEP, you must also provide a notice of any excess contributions.

If you do not use Form 5305–SEP (or Form 5305A–SEP if it applies) to set up your SEP, you must give your employees general information about the SEP. The information must satisfy the Internal Revenue Code reporting and disclosure requirements. For guidance, see the preceding paragraph.

SIMPLE Plans

A savings incentive match plan for employees (SIMPLE plan) is a written salary reduction arrangement that allows a small business (generally an employer with 100 or fewer employees) to make elective contributions on behalf of each eligible employee. SIMPLE plans can only be maintained on a calendar-year basis. A SIMPLE plan can be set up using IRAs (SIMPLE IRA plans) or as part of a 401(k) plan.

SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses IRAs for each of the participants.

Definitions

The following definitions apply to SIMPLE IRA plans.

SIMPLE retirement account. The SIMPLE retirement account of an ***eligible employee*** is an individual retirement plan (a SIMPLE IRA) that can be either an individual retirement account or an individual retirement annuity, as described in Publication 590. Employees' rights to the contributions cannot be forfeited.

Qualified salary reduction arrangement. An employee eligible to participate in the SIMPLE plan may elect (during the 60–day period before the beginning of any year) to have the employer make contributions (called elective deferrals) to the SIMPLE retirement account on his or her behalf. An employee who so elects may also stop making elective deferrals at any time during the year. The employer is required to match the employee's contributions or to make nonelective contributions. No other types of contributions are allowed under the qualified salary reduction arrangement.

Eligible employee. Any employee who received at least $5,000 in compensation during any 2 years preceding the calendar year and is reasonably expected to earn at least $5,000 during this calendar year can elect to have you (the employer) make contributions to a SIMPLE retirement account under a qualified salary reduction arrangement. You can establish less restrictive eligibility requirements for employees, but not more restrictive ones.

Excludable employees. The following employees need not be covered under a SIMPLE plan:

1) Employees who are covered by a union agreement and whose retirement benefits were bargained for in good faith by their union and you, and
2) Nonresident alien employees who have no U.S.-source earned income from you.

Compensation. Compensation for employees is the total amount of wages required to be reported on Form W-2, including elective deferrals. For the self-employed individual, compensation is the net earnings from self-employment (before subtracting any contributions made to the SIMPLE IRA plan for the self-employed individual).

Any SIMPLE IRA plan elective deferrals relating to an employee's wages under a salary reduction arrangement are included in the Form W-2 wages for social security and Medicare tax purposes only.

Setting Up a SIMPLE IRA Plan

If an employer has 100 or fewer employees (who received at least $5,000 of compensation from the employer for the preceding year), the employer may be able to set up a SIMPLE IRA plan on behalf of eligible employees. An eligible employer who establishes and maintains a SIMPLE IRA plan for at least 1 year shall be treated as an eligible employer for the 2 years following the last year actually eligible.

The SIMPLE IRA plan generally must be the only retirement plan of the employer to which contributions are made, or benefits are accrued, for service in any year beginning with the year the SIMPLE IRA plan becomes effective.

An employer who maintains a qualified plan for collective bargaining employees is permitted to maintain a SIMPLE IRA plan for noncollectively bargained employees.

Under a SIMPLE IRA plan, the employer's contributions on behalf of the employee (elective deferrals) are stated as a percentage of the employee's ***compensation*** and are limited to $6,000. The dollar limit is indexed for inflation in $500 increments.

The terms emphasized here are defined earlier in detail.

Under a SIMPLE IRA plan the employer is also required to make either a matching contribution to the SIMPLE retirement account on behalf of each employee who elects to make elective deferrals, or a nonelective contribution to the ***SIMPLE retirement account*** on behalf of each eligible employee. These two methods for determining the employer contribution formula are explained under *Employer matching contributions* and *2% nonelective contributions.*

Contributions to a SIMPLE IRA plan are deductible by the employer and are excluded from the gross income of the employee.

Contribution Limits

Contributions are made up of employee elective deferrals and employer contributions. The employer is required to make either matching contributions or nonelective contributions. No other contributions can be made to the SIMPLE IRA plan. These contributions, which are deductible by the employer, must be made timely. See *Time limits for contributing funds,* later.

Employee elective deferral limit. The amount that the employee elects to have the employer contribute to a SIMPLE retirement account on his or her behalf (elective deferrals) must not exceed $6,000 for 1997 and must be expressed as a percentage of the employee's compensation.

Employer matching contributions. The employer generally is required to match each employee's contributions (elective deferrals), on a dollar-for-dollar basis, in an amount not to exceed 3% of the employee's compensation.

Lower percentage elected. If the employer elects a matching contribution that is less than 3%, the percentage must not be less than 1%. The employer must **notify the employees** of the lower match within a reasonable period of time before the employee's 60–day election period (discussed later) for the calendar year. A percentage less than 3% cannot be elected for more than 2 years during a 5-year period.

2% nonelective contributions. Instead of matching contributions, the employer can elect to make nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from the employer for the year. Only $160,000 of the employee's compensation can be taken into account to figure the contribution limit.

If the employer elects this 2% contribution formula, he or she must **notify the employees** within a reasonable period of time before the employee's 60–day election period (discussed later) for the calendar year.

Time limits for contributing funds. The employer is required to contribute the elective deferrals to the SIMPLE retirement accounts, within 30 days after the end of the month for which the payments to the employee were deferred. The employer's matching contributions or nonelective contributions must be made by the due date (including extensions) for filing the employer's income tax return for the year.

Distributions (Withdrawals)

Distributions from a SIMPLE retirement account are subject to IRA rules and, generally, are includible in income for the year received. Tax-free rollovers can be made from one SIMPLE retirement account into another SIMPLE retirement account or into an IRA. Early withdrawals generally are subject to a 10% (or 25%) additional tax.

A rollover to an IRA can be made tax free only after a 2–year participation in the SIMPLE IRA plan. A 25% additional tax for early

withdrawals applies if funds are withdrawn within 2 years of beginning participation.

More information. See Publication 590 for information about IRA rules, including those on the tax treatment of distributions, rollovers, required distributions, and income tax withholding.

Administrative and Notification Requirements

Before the beginning of the employee's 60-day election period, the employer who adopts a SIMPLE IRA plan must notify each employee of the:

1) Employee's opportunity to make, modify, or terminate a salary reduction election under a SIMPLE IRA plan,
2) Employer's election to make either reduced matching contributions or nonelective contributions (discussed earlier), and
3) Summary description of the plan.

In the event the employer uses a designated financial institution, each employee must be notified in writing that his or her balance can be transferred without cost or penalty.

60-day employee election period. The 60–day election period is generally the 60–day period immediately preceding January 1 of a calendar year (i.e., November 2 to December 31 of the preceding calendar year). However, the rule is modified if an employer establishes a SIMPLE IRA plan in mid year (e.g., July 1, 1997) or if the 60–day period falls before the first day an employee becomes eligible to participate in the SIMPLE IRA plan.

What forms can an employer use to establish a SIMPLE IRA plan? The employer who establishes a SIMPLE IRA plan may use either Form 5305–SIMPLE or Form 5304–SIMPLE. Each form is a model savings incentive match plan for employees of small employers (SIMPLE) plan document. The form that is used to establish the SIMPLE IRA plan depends on whether or not a designated financial institution is selected. As discussed below, the employer can either permit employees to select the institution and trustee for SIMPLE IRA plan contributions, or send contributions for all employees to one financial institution.

Form 5304–SIMPLE (for non-designated financial institution). Form 5304–SIMPLE allows each plan participant to select the financial institution for receiving his or her SIMPLE IRA plan contributions.

Form 5305–SIMPLE (for use with a designated financial institution). Form 5305–SIMPLE is used if the employer requires that all contributions under the SIMPLE IRA plan be deposited at a designated financial institution.

For the 1997 calendar year, a model SIMPLE IRA plan using either form can be made effective as late as October 1, 1997.

Purpose of model plan documents. If an eligible employer sets up a SIMPLE IRA plan using Form 5304–SIMPLE (or Form 5305–SIMPLE), these forms can be used to simplify other requirements, including:

1) Meeting employer notification requirements for the SIMPLE IRA plan. Page 3 of Form 5304–SIMPLE and Form 5305–SIMPLE contain a *Model Notification to Eligible Employees* that provides the necessary information to the employee, and
2) Maintaining the SIMPLE IRA plan records and as proof of having established a SIMPLE IRA plan for employees. These forms are not required to be filed with the IRS.

Purpose of Forms 5305–S and 5305–SA. Forms 5305–S and 5305–SA are model trust and custodial account documents that can be used by the participant and the trustee (or custodian) to set up the SIMPLE IRAs to receive contributions made under a SIMPLE IRA plan.

SIMPLE 401(k) Plan

A SIMPLE plan can be adopted as part of a 401(k) plan. A SIMPLE 401(k) plan generally must satisfy the rules that apply to all 401(k) plans, as discussed in *Keogh Plan Qualification Rules* under *Keogh Plans,* later. However, contributions and benefits under a SIMPLE plan will be considered not to discriminate in favor of highly compensated employees provided the plan meets the conditions listed below.

1) Under the plan, an employee can elect to have the employer make elective deferrals for the year to a trust in an amount expressed as a percentage of the employee's compensation, but not to exceed $6,000 for 1997.
2) The employer is required to make either:
   a) A matching contribution not to exceed 3% of compensation for the year, or
   b) Nonelective contributions of 2% of compensation on behalf of each eligible employee who has at least $5,000 of compensation from the employer for the year.
3) No other contributions can be made to the trust.
4) No contributions are made, and no benefits accrue, for services during the year under any other qualified retirement plan of the employer on behalf of any employee eligible to participate in the SIMPLE plan.
5) The employee's rights to any contributions are nonforfeitable.

Top-heavy plan exception. A SIMPLE 401(k) plan that allows only contributions meeting the conditions listed above will not be treated as a top-heavy plan. Top-heavy Keogh plans are discussed in *Top-heavy plan requirements* under *Keogh Plans,* later.

Employee notification. The notification rules that apply to SIMPLE IRA plans also apply to SIMPLE 401(k)s. See *Administrative and Notification Requirements,* earlier.

More information. An employer who needs additional guidance to establish and maintain SIMPLE IRA plans and SIMPLE 401(k) plans can get information from the Internal Revenue Bulletin (IRB), as well as from the forms and instructions discussed earlier.

1) **Notice 98–4.** This notice (1998–2 IRB 25) contains questions and answers relating to the implementation and operation of SIMPLE IRA plans, including the election and notice requirements regarding these plans.
2) **Rev. Proc. 97–29.** This revenue procedure (1997–24 IRB 9) provides:
   a) A model amendment that can be used (prior to 1999) by a sponsor of a prototype IRA to establish a SIMPLE IRA,
   b) Guidance on obtaining opinion letters to drafters of prototype SIMPLE IRA, and
   c) Transitional relief for users of SIMPLE IRA and SIMPLE IRA plans that have not been approved by the IRS.
3) **Rev. Proc. 97–9.** This revenue procedure (1997–2 IRB 55) provides a model amendment that an employer can use to adopt a plan with SIMPLE 401(k) provisions. This model amendment provides guidance to plan sponsors for incorporating 401(k) SIMPLE provisions in plans containing cash or deferred arrangements.

Keogh Plans

Terms you may need to know (see Glossary):

Annual addition
Annual benefit
Business
Common-law employee
Compensation
Contribution
Deduction
Earned income
Employee
Employer
Master plan
Net earnings from self-employment
Partner
Self-employed individual
Sole proprietor

A qualified employer plan set up by a self-employed person is sometimes called a Keogh or HR–10 plan. Only a sole proprietor or a partnership can establish a Keogh plan. A common-law employee or a partner cannot. See the glossary definitions for more information.

The plan must be for the exclusive benefit of employees or their beneficiaries. A Keogh plan ***includes coverage for a self-employed individual.*** For Keogh plan purposes, a self-employed individual is both an employer and an employee.

As an employer, you can usually deduct, subject to limits, contributions you make to a Keogh plan, including those made for your own retirement. The contributions (and earnings and gains on them) are generally tax free until distributed by the plan.

Figure 1. **Setting Up A Keogh Plan**

To set up a Keogh plan, you can:

Adopt an IRS-approved prototype or master plan offered by a sponsoring organization

or

Prepare and adopt a written plan that satisfies the qualification requirements of the Internal Revenue Code

Then you must:

Establish a trust or custodial account for investment of funds

or

Buy an annuity contract or face amount certificates from an insurance company

Setting Up a Keogh Plan

If you are self-employed, it is not necessary to have employees besides yourself to sponsor and set up a Keogh plan. If you have employees, you must allow them to participate in the plan if they meet the ***minimum participation requirements*** (or the requirements of your plan, if more lenient).

You, the employer, are responsible for establishing and maintaining the plan.

Minimum participation requirements. An employee must be allowed to participate in your plan if he or she:

- Has reached age 21, and
- Has at least one year of service (2 years if the plan provides that after not more than 2 years of service the employee has a nonforfeitable right to all of his or her accrued benefit).

A plan cannot exclude an employee because he or she has reached a specified age.

Written plan requirement. To qualify, the plan you establish must be in writing and must be communicated to your employees. The plan's provisions must be stated in the plan. It is not sufficient for the plan to merely refer to a requirement of the Internal Revenue Code.

Master or prototype plans. Most Keogh plans follow a standard form of plan (a master or prototype plan) approved by the IRS. You can adopt an approved master or prototype plan offered by an organization that provides these types of plans.

Plan providers. The following organizations generally can provide IRS-approved master or prototype plans:

- Banks (including some savings and loan associations and federally insured credit unions),
- Trade or professional organizations,
- Insurance companies, and
- Mutual funds.

Individually designed plans. If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by paying a fee and requesting a determination letter. You may need professional assistance for this. A reading of Revenue Procedure 97–6 may help you decide whether to apply for approval of your plan. It is available at most IRS offices and at some libraries.

Investing plan assets. In setting up a Keogh plan, you arrange how the plan's funds will be used to build its assets.

- You can establish a trust or custodial account to invest the funds.
- You, the trust, or the custodial account can buy an annuity contract from an insurance company. Life insurance can be included only if it is incidental to the retirement benefits.
- You, the trust, or the custodial account can buy face-amount certificates from an insurance company. These certificates are treated like annuity contracts.

You establish a trust by a legal instrument (written document). You may need professional assistance to do this.

You can establish a custodial account with a bank, savings and loan association, credit union, or other person who can act as the plan trustee.

You do not need a trust or custodial account, although you can have one, to invest the plan's funds in annuity contracts or face-amount certificates. If anyone other than a trustee holds them, however, the contracts or certificates must state that they are not transferable.

Other plan requirements. For information on other important plan requirements, see *Keogh Plan Qualification Rules,* later.

Set-up deadline. To take a deduction for contributions for a tax year, your plan must be set up (adopted) by the last day of that year (December 31 for calendar-year employers).

Contribution deadline. You can make deductible contributions for a tax year up to the due date of your return (plus extensions) for that year.

Kinds of Plans

There are two basic kinds of Keogh plans, ***defined contribution plans*** and ***defined benefit plans***, and different rules apply to each. You can have more than one Keogh plan, but your contributions to all the plans must not exceed the overall limits discussed under *Contributions* and *Employer Deduction,* later.

Defined Contribution Plan

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Benefits are also affected by any income, expenses, gains and losses, and any forfeitures of other accounts that may be allocated to an account. A defined contribution plan can be either a profit-sharing or a money purchase pension plan.

Profit-sharing plan. A profit-sharing plan is a plan for sharing employer profits with the firm's employees. However, an employer does not have to make contributions out of net profits to have a profit-sharing plan.

The plan need not provide a definite formula for figuring the profits to be shared. But, if there is no formula, there must be systematic and substantial contributions.

The plan must provide a definite formula for allocating the contribution among the participants, and for distributing the accumulated funds to the employees after they reach a certain age, after a fixed number of years, or upon certain other occurrences.

In general, you can be more flexible in making contributions to a profit-sharing plan than to a money purchase pension plan (discussed next) or a defined benefit plan (discussed later). But the maximum deductible contribution may be less under a profit-sharing plan (see *Limits on Contributions and Benefits,* later).

Forfeitures under a profit-sharing plan can be allocated to the accounts of remaining participants in a nondiscriminatory way, or they can be used to reduce employer contributions.

Money purchase pension plan. Contributions to a money purchase pension plan are fixed and are not based on the employer's profits. For example, if the plan requires that contributions be 10% of the participant's compensation without regard to whether the employer has profits (or the self-employed person has earned income), the plan is a money purchase pension plan. This applies even though the compensation of a self-employed individual as a participant is based on earned income derived from business profits.

Defined Benefit Plan

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on a computation of what contributions are needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, you will need continuing professional help to have a defined benefit plan.

Forfeitures under a defined benefit plan cannot be used to increase the benefits any employee would otherwise receive under the plan. Forfeitures must be used instead to reduce employer contributions.

Minimum Funding Requirements

In general, if your Keogh plan is a ***money purchase pension plan*** or a ***defined benefit plan,*** you must actually pay enough into the plan to satisfy the minimum funding standard for each year. Determining the amount needed to satisfy the minimum funding standard is complicated. The determination is based on what should be contributed under the plan formula using actuarial assumptions and formulas. For information on this funding requirement, see Internal Revenue Code Section 412 and the regulations under that section. (Most libraries have the Internal Revenue Code.)

Quarterly installments of required contributions. If your Keogh plan is a ***defined benefit plan*** subject to the minimum funding requirements, you must make quarterly installment payments of the required contributions. If you do not pay the full installments timely, you may have to pay interest on any underpayment for the period of the underpayment.

Due dates. The due dates for the installments are 15 days after the end of each quarter. For a calendar-year plan, the installments are due April 15, July 15, October 15, and January 15 (of the following year).

Installment percentage. Each quarterly installment must be 25% of the required annual payment.

Extended period for making contributions. Additional contributions required to satisfy the minimum funding requirement for a plan year will be considered timely if made by eight and one-half months after the end of that year.

Contributions

A Keogh plan is generally funded by employer contributions. However, employees participating in the plan may be permitted to make contributions.

Self-employed individual. You can make contributions for yourself ***only if*** you have net earnings (compensation) from self-employment in the trade or business for which the plan was established. If you have a net loss from self-employment, you cannot make contributions for yourself for the year, even if you can contribute for common-law employees based on their compensation. Your net earnings must be from your personal services, not from your investments.

Employer Contributions

There are certain limits on the contributions and other annual additions you can make each year for plan participants. There are also limits on the amount you can deduct. See *Deduction Limits,* later.

Limits on Contributions and Benefits

Your plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether your Keogh plan is a defined contribution plan or a defined benefit plan.

Defined benefit plan. For 1997 the annual ***benefit*** for a participant under a defined benefit plan cannot be more than the **smaller** of:

1) $125,000, or

2) 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.

Defined contribution plan. A defined contribution plan's annual ***contributions*** and other additions (excluding earnings) to the account of a participant cannot exceed the **smaller** of:

1) $30,000, or

2) 25% of the compensation actually paid the participant.

The maximum compensation that can be taken into account for this limit is generally $160,000.

Amounts contributed in excess of these limits (excess annual additions). A plan can correct excess annual additions because of:

- A reasonable error in estimating a participant's compensation,
- A reasonable error in determining the amount of elective deferrals permitted (discussed later), or
- Forfeitures allocated to participants' accounts.

Correcting excess annual additions. A plan can provide for the correction of excess contributions in the following ways:

1) Allocate and reallocate the excess to other participants in the plan to the extent of their unused limits for the year; or, if these limits are exceeded,

2) Hold the excess in a separate account and allocate (and reallocate) it to participants' accounts in the following year (or years) before making any contributions for that year (see also *Carryover of Excess Contributions,* later); or

3) Return employee after-tax contributions or elective deferrals (see *Employee Contributions* and *Elective Deferrals (401(k) Plans),* later).

Tax treatment of returned contributions or distributed elective deferrals. The return of employee after-tax contributions or the distribution of elective deferrals to correct excess annual additions is considered a corrective payment rather than a distribution of accrued benefits. The penalties for premature (early) distributions and excess distributions do not apply.

These disbursements ***are not wages reportable on Form W–2.*** You must report them on a separate Form 1099–R as follows:

- Report the total amount of the distribution, including employee contributions, in box 1. If the distribution includes any gain from the contribution, report it in box 2a. Report the return of employee contributions in box 5. Enter Code E in box 7.
- Report a distribution of an elective deferral in boxes 1 and 2a. Include any gain from the contribution. Leave box 5 blank and enter Code E in box 7.

Participants must report these amounts on the line for *Total pensions and annuities* on Form 1040 or Form 1040A.

Employee Contributions

Participants may be permitted to make nondeductible contributions to a plan in addition to the employer contributions. Even though these employee contributions are not deductible, the earnings on them are tax free until distributed in later years. But see *Excise Tax for Nondeductible (Excess) Contributions,* later. Also, these contributions must satisfy the nondiscrimination test of section 401(m) of the Internal Revenue Code.

When Contributions Are Considered Made

You generally apply your Keogh plan contributions to the year in which you make them. But you can apply them to the previous year if:

1) You make them by the due date of your tax return for the previous year (plus extensions);

2) The plan was established by the end of the previous year;

3) The plan treats the contributions as though it had received them on the last day of the previous year; and

4) Either—

   a) You specify in writing to the plan administrator or trustee that the contributions apply to the previous year; or

   b) You deduct the contributions on your tax return for the previous year. (A partnership shows contributions for partners on Schedule K (Form 1065)).

Employer's promissory note. Your promissory note made out to the plan is not a payment for purposes of the Keogh deduction. Also, issuing this note is a prohibited transaction subject to tax. See *Prohibited Transactions,* later.

Employer Deduction

Only a sole proprietor or a partnership can establish a Keogh plan.

Deduction Limits

The limit on your deduction for your contributions to a Keogh plan depends on the kind of plan you have.

Defined contribution plans. The deduction limit for a defined contribution plan depends on whether it is a profit-sharing plan or a money purchase pension plan.

Profit-sharing plan. Your deduction for contributions to a profit-sharing plan cannot be more than ***15%*** of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. You must reduce this 15% limit in figuring the deduction for contributions you make for your own account. See *Deducting Contributions for Yourself,* later.

Money purchase pension plan. Your deduction for contributions to a money purchase pension plan is generally limited to ***25%*** of the compensation from the business paid during the year to a participating common-law employee. You must reduce this 25% limit in figuring the deduction for contributions you make for yourself, as discussed later.

Defined benefit plans. The deduction for contributions to a defined benefit plan is based on actuarial assumptions and computations. Consequently, an actuary must figure your deduction limit.

In figuring the deduction for contributions, you cannot take into account any contributions or benefits that exceed the limits discussed earlier under *Limits on Contributions and Benefits.*

Table 1. **Key Retirement Plan Rules**

Type of Plan	Last Date for Contribution	Maximum Contribution	When To Begin Distributions[1]
IRA	Due date of contributor's income tax return (NOT including extensions)	Smaller of $2,000 or taxable compensation	April 1 of year after year IRA owner reaches age 70½
SEP-IRA	Due date of employer's return (including extensions)	Smaller of $30,000 or 15%[2] of participant's taxable compensation[3]	April 1 of year after year participant reaches age 70½
SIMPLE **IRA**	**Elective employer contributions:** 30 days following the end of the month with respect to which the contributions are to be made. **Matching contributions or nonelective contributions:** Due date of employer's return (including extensions)	**Employee:** Salary reduction contribution, *up* to $6,000. **Employer contribution:** *either* dollar-for-dollar matching contributions, up to 3% of employee's compensation, *or* fixed nonelective contributions of 2% of compensation[3]	April 1 of year after year participant reaches age 70½
Keogh	Due date of employer's return (including extensions)	Defined Contribution Plans Employee: ***Money Purchase***–Smaller of $30,000 or 25% of employee's taxable compensation[3] ***Profit-Sharing***–Smaller of $30,000 or 25% of employee's taxable compensation[3] Self-Employed Individual: ***Money Purchase***–Smaller of $30,000 or 25% of self-employed participant's taxable compensation[4] ***Profit-Sharing***–Smaller of $30,000 or 25% of self-employed participant's taxable compensation[4] Defined Benefit Plans Amount needed to provide an annual retirement benefit no larger than the smaller of $125,000 or 100% of the participant's average taxable compensation for his or her highest 3 consecutive years	Generally, April 1 of year that follows the later of the year participant reaches age 70½ or the year in which he or she retires

[1] Distributions of at least the required minimum amount must be made each year if the entire balance is not distributed.
[2] Net earnings from self-employment must take the contribution into account.
[3] Generally limited to $160,000.
[4] Compensation is before adjustment for this contribution.

Deducting contributions to combination of plans. If you contribute to both a defined contribution plan and a defined benefit plan, and at least one employee is covered by both plans, your deduction for those contributions is limited. Your deduction cannot exceed the ***greater*** of:

- 25% of the compensation from the business paid (or accrued) during the year to the common-law employees participating in the plan. (You must reduce this 25% limit in figuring the deduction for contributions you make for your own account.), or
- Your contributions to the defined benefit plans, but not more than the amount needed to meet the year's minimum funding standard for any of these plans.

For purposes of this rule, a Simplified Employee Pension (SEP) plan is treated as a separate profit-sharing (defined contribution) plan.

Deducting Contributions for Yourself

When figuring the deduction for contributions made for yourself, compensation is your net earnings from self-employment which does not include:

1) The deduction allowed to you for one-half of the self-employment tax, and
2) The deduction for contributions on behalf of yourself to the plan.

The deduction amount for (2) above is determined indirectly by using a *self-employed person's contribution rate.* See *Deduction of Contributions for Sel-Employed,* earlier, in the Simplified Employee Pension (SEP) section.

Combination of plans. The limit on the combined deduction of contributions to a combination of plans also applies to contributions you make as an employer on your own behalf. See *Deducting contributions to combination of plans,* earlier.

Where To Deduct on Form 1040

Deduct the contributions for your *common-law employees* on Schedule C (Form 1040), on Schedule F (Form 1040), or on Form 1065, whichever applies to you.

Take the deduction for contributions for yourself on line 28 of Form 1040.

If you are a partner, the partnership passes its deduction to you for the contributions it made for you. The partnership will report these contributions on Schedule K–1 (Form 1065). You deduct them by entering the amount on line 28 of Form 1040.

Carryover of Excess Contributions

If you contribute more to the plans than you can deduct for the year, you can carry over and deduct the excess in later years, combined with your deduction for those years. Your combined deduction in a later year is limited to 25% of the participating employees' compensation for that year. The limit is 15%

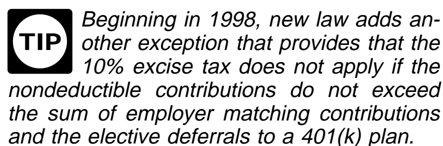
if you have only profit-sharing plans. Remember that these percentage limits must be reduced to figure your maximum deduction for contributions you make for yourself. See *Deducting Contributions for Yourself,* earlier. The excess you carry over and deduct may be subject to the excise tax discussed next.

Excise Tax for Nondeductible (Excess) Contributions

If you contribute more than your deduction limit to a retirement plan, you have made nondeductible contributions and you may be liable for an excise tax. In general, a 10% excise tax applies to nondeductible contributions made to qualified pension, profit-sharing, stock bonus, or annuity plans, and to simplified employee pension plans (SEPs).

Special rule for self-employed individuals. The 10% excise tax does not apply to any contribution to meet the *minimum funding requirements* in a money purchase pension plan or a defined benefit plan. Even if that contribution is more than your earned income from the trade or business for which the plan is set up, the excess is treated as a deductible contribution, which is not subject to this excise tax. See *Minimum Funding Requirements* earlier in this section.

6% of compensation exception. This 10% excise tax does not apply to contributions to one or more defined contribution plans which are not deductible only because they exceed the combined plan deduction limit, and then only to the extent the excess does not exceed 6% of the participants' compensation for the year.



Beginning in 1998, new law adds another exception that provides that the 10% excise tax does not apply if the nondeductible contributions do not exceed the sum of employer matching contributions and the elective deferrals to a 401(k) plan.

Reporting the tax. You must report the tax on your nondeductible contributions on Form 5330. Form 5330 includes a computation of the tax. See the separate instructions for completing the form.

Elective Deferrals (401(k) Plans)

Your Keogh plan can include a cash or deferred arrangement (401(k) plan) under which eligible employees can elect to have you contribute part of their before-tax pay to the plan rather than receive the pay in cash. (As a participant in the plan, you can contribute part of your before-tax net earnings from the business.) This contribution, called an ***elective deferral*** (and any earnings on it), remains tax free until it is distributed by the plan.

In general, a Keogh plan can include a 401(k) plan only if the Keogh is:

- A profit-sharing plan, or
- A money purchase pension plan in existence on June 27, 1974, that included a salary reduction arrangement on that date.

Restriction on conditions of participation. The plan may not require, as a condition of participation, that an employee complete more than one year of service.

Matching contributions. If your plan permits, you can make additional (matching) contributions for an employee on account of the contributions on behalf of the employee under the deferral election just discussed. For example, the plan might provide that you will contribute 50 cents for each dollar your participating employees elect to defer under your 401(k) plan.

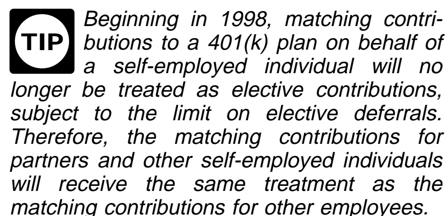
Nonelective contributions. You can, under a qualified 401(k) plan, also make contributions (other than matching contributions) for your participating employees without giving them the choice to take cash instead.

Partnership. A partnership can have a 401(k) plan.

Limit on Elective Deferrals

There is a limit on the amount that an employee can defer each year under these plans. This limit applies without regard to community property laws. Your plan must provide that your employees cannot defer more than the limit that applies for a particular year. For 1997 the basic limit on elective deferrals is ***$9,500.*** This limit is subject to annual increases to reflect inflation (as measured by the Consumer Price Index). If, in conjunction with other plans, the deferral limit is exceeded, the excess is included in the employee's gross income.

Treatment of self-employed individual matching contributions. Matching contributions made for a self-employed individual to a 401(k) plan in 1997 are treated as additional elective contributions. These contributions are therefore subject to the $9,500 limit on elective deferrals discussed earlier.



Beginning in 1998, matching contributions to a 401(k) plan on behalf of a self-employed individual will no longer be treated as elective contributions, subject to the limit on elective deferrals. Therefore, the matching contributions for partners and other self-employed individuals will receive the same treatment as the matching contributions for other employees.

Treatment of contributions. Your contributions to a 401(k) plan are generally deductible by you and tax free to participating employees until distributed from the plan. Participating employees have a nonforfeitable right to the accrued benefit resulting from these contributions. Deferrals are included in wages for social security, Medicare, and federal unemployment (FUTA) tax purposes.

Reporting on Form W–2. You must report the total amount deferred in boxes 3, 5, and 13 of your employee's Form W–2, *Wage and Tax Statement.* See the Form W–2 instructions.

Treatment of Excess Deferrals

If the total of an employee's deferrals exceeds the limit for 1997, the employee can have the excess deferral paid out of any of the plans that permit these distributions. He or she must tell each plan by March 2, 1998, the amount to be paid from that particular plan. The plan must then pay the employee that amount by April 15, 1998.

Excess withdrawn by April 15. If the employee takes out the excess deferral by April 15, 1998, it is not reported again by including it in the employee's gross income for 1998. However, any ***income earned*** on the excess deferral taken out is taxable in the tax year in which it is taken out. The distribution is not subject to the additional 10% tax on premature (early) distributions.

If the employee takes out ***part*** of the excess deferral and the income on it, the distribution is treated as made proportionately from the excess deferral and the income.

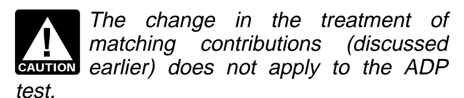
Excess not withdrawn by April 15. If the employee does not take out the excess deferral by April 15, the excess, though taxable in 1997, is not included in the employee's cost basis in figuring the taxable amount of any eventual benefits or distributions under the plan. In effect, an excess deferral left in the plan is taxed twice, once when contributed and again when distributed. Also, if the entire deferral is allowed to stay in the plan, the plan may not be a qualified plan.

Even if the employee takes out the excess deferral by April 15, the amount is considered contributed for purposes of satisfying (or not satisfying) the nondiscrimination requirements of the plan. See *Contributions or benefits must not discriminate* later, under *Keogh Plan Qualification Rules.*

Reporting corrective distributions on Form 1099–R. Report corrective distributions of excess deferrals (including any earnings) on Form 1099–R. If you need specific information about reporting corrective distributions, see the 1997 *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Tax on certain excess deferrals. The law provides tests to detect discrimination in a plan. If tests, such as the *actual deferral percentage test (ADP)* (see section 401(k)(3)) (or 408(k)(6)(A) in the case of salary reduction SEPs)) and the *contribution percentage test* (see section 401(m)(2)) show that contributions for highly compensated employees exceed the test limits for these contributions, the employer may have to pay a ***10% excise tax.*** Report the tax on Form 5330.

The tax for the year is equal to 10% of the excess contributions for the plan year ending in your tax year. Excess contributions are elective deferrals, employee contributions, or employer matching or nonelective contributions that exceed the amount permitted under the ADP test or the contribution percentage test.



The change in the treatment of matching contributions (discussed earlier) does not apply to the ADP test.

Distributions

Amounts paid to plan participants from a Keogh plan are distributions. Distributions may be nonperiodic, such as a lump-sum distribution, or periodic, such as annuity payments. Also, certain loans may be treated as distributions. See *Loans Treated as Distributions* in Publication 575.

Table 2. **Carryover of Excess Contributions Illustrated—Profit-Sharing Plan (000's omitted)**

Year	Participants' compensation	Participants' share of required contribution (10 percent of annual profit)	Deductible limit for current year (15 percent of compensation)	Contribution	Excess contribution carryover used*	Total deductible including carryovers	Excess contribution carryover available at end of year
1994 . . .	$1,000	$100	$150	$100	$ 0	$100	$ 0
1995 . . .	400	125	60	125	0	60	65
1996 . . .	500	50	75	50	25	75	40
1997 . . .	600	100	90	100	0	90	50

* There were no carryovers from years before 1994.

Required Distributions

A Keogh plan must provide that each participant will either:

1) Receive his or her entire interest (benefits) in the plan by the ***required beginning date*** (defined below), ***or***

2) Begin receiving regular periodic distributions by the required beginning date in annual amounts calculated to distribute the participant's entire interest (benefits) over his or her life expectancy or over the joint life expectancy of the participant and the designated beneficiary. This is the required ***minimum distribution.*** Regular periodic distributions can be paid out over a shorter period and in larger amounts, but they cannot be paid out over a longer period in smaller amounts. Minimum distributions must meet the ***minimum distribution incidental benefit*** requirement. For more information about this and other distribution requirements, get Publication 575.

The minimum distribution rules apply individually to each Keogh plan. You cannot satisfy the requirement for one plan by taking a distribution from another. These rules may be incorporated in the plan by reference. The plan must provide that these rules override any inconsistent distribution options previously offered.

Figuring the minimum distribution. If the account balance of a Keogh plan participant is to be distributed (other than as an annuity), the plan administrator must figure the minimum amount required to be distributed each distribution calendar year. This amount is figured by dividing the ***account balance*** by the ***applicable life expectancy*** (discussed under *Tax on Excess Accumulation* and its discussion on minimum distributions in Publication 575).

Account balance. Use the value of the account balance as of the last valuation date in the calendar year preceding the distribution calendar year, adjusted as follows:

1) Add amounts allocated to the account balance after the valuation date in the preceding calendar year. Include contributions allocated to the preceding year that were made after the close of that year.

2) Subtract distributions during the preceding year that were made after the valuation date. Also subtract distributions made during the second distribution calendar year to meet the minimum distribution required for the first distribution calendar year.

Required beginning date. Generally, each participant must receive his or her entire benefits in the plan or begin to receive periodic distributions of benefits from the plan by the required beginning date.

Beginning in 1997, a participant must begin to receive distributions from his or her qualified retirement plan by April 1 of the year that follows the **later of** the:

1) Calendar year in which he or she reaches age 70½, or

2) Calendar year in which he or she retires.

Before 1997, the law did not take into account whether or not the participant had retired. A participant was required to begin receiving distributions by April 1 of the year following the calendar year in which the participant reached age 70½. This rule still applies if the participant is a 5% owner or the distribution is from an IRA. For more information, see *Tax on Excess Accumulation* in Publication 575.

Exception. A 5% owner must still begin to receive distributions on April 1 of the year following the calendar year in which he or she reaches age 70½.

Distributions after required beginning date. The required minimum distribution for any year after the participant's required beginning date must be made by December 31 of the later year. If no distributions are made in the participant's 70½ year (or when he or she retires), required minimum distributions for 2 years must be made in the next year (one by April 1, and one by December 31).

See Publication 575 for the special rules covering distributions made after the death of a participant.

Distributions From 401(k) Plans

Generally, a distribution may not be made until the employee:

- Retires,
- Dies,
- Becomes disabled, or
- Otherwise separates from service.

Also, a distribution may be made if the plan ends and no other defined contribution plan is established or continued. In the case of a 401(k) plan that is part of a profit-sharing plan, a distribution may be made if the employee reaches age 59½ or suffers financial hardship.

Some of the above distributions may be subject to the tax on premature distributions discussed later.

Hardship distribution. For the rules on hardship distributions, including the limits on them, see Treasury Regulation 1.401(k)–1(d)(2).

Qualified domestic relations order (QDRO). These distribution restrictions do not apply if the distribution is to an alternate payee under the terms of a QDRO. QDRO is defined in Publication 575.

Tax Treatment of Distributions

Distributions from a Keogh plan minus a prorated part of any cost basis are subject to income tax in the year they are distributed. Since most recipients have no cost basis, a distribution is generally fully taxable. An exception is a distribution that is properly rolled over as discussed next under *Rollover.*

The tax treatment of distributions depends on whether they are made periodically over several years or life ***(periodic payments)***, or are ***nonperiodic distributions.*** See *Taxation of Periodic Payments* or *Taxation of Nonperiodic Payments* in Publication 575 for a detailed description of how distributions are taxed, including the 5– or 10–year tax option or capital gain treatment of a ***lump-sum distribution***.

Rollover

The recipient of an *eligible rollover distribution* from a Keogh plan can defer the tax on it by rolling it over into an IRA or another eligible retirement plan. However, it may be subject to withholding as discussed under *Withholding Requirements,* later.

Eligible rollover distribution. This is a distribution of all (such as a lump-sum distribution) or any part of an employee's balance in a qualified retirement plan (such as a Keogh plan) that *is not:*

- A required distribution. See *Required Distributions,* earlier.
- An annual (or more frequent) payment under a long-term (10 years or more) annuity contract or as part of a similar long-term series of substantially equal periodic distributions.
- The portion of a distribution that represents the return of an employee's nondeductible contributions to the plan. See *Employee Contributions,* earlier.

- A distribution such as a return of excess contributions or deferrals under a 401(k) plan. See *Correcting excess annual additions,* earlier, under *Limits on Contributions and Benefits.*

More information. For more information about rollovers, see *Rollovers* in Publications 575 and 590.

Withholding Requirements

If, during a year, a Keogh plan pays to a participant one or more *eligible rollover distributions* (defined in the preceding discussion) that are reasonably expected to total more than $200, the payor must withhold 20% of each distribution for federal income tax.

Exceptions. If, instead of having the distribution paid to him or her, the participant chooses to have the plan pay it directly to an IRA or another eligible retirement plan (a *direct rollover*), no withholding is required.

Or, if the participant receives a *distribution that is not eligible for rollover treatment* (see the list of these distributions excluded from the definition of an *eligible rollover distribution,* earlier), the 20% withholding requirement does not apply. Other withholding rules apply to these excluded distributions, such as long-term periodic distributions and required distributions (periodic or nonperiodic). However, the participant can still choose not to have tax withheld from these distributions. If the participant does not make this choice, the following withholding rules apply:

- For periodic distributions, withholding is based on their treatment as wages, and
- For nonperiodic distributions, 10% of the taxable part is withheld.

Estimated tax payments. If no income tax is withheld or not enough tax is withheld, the recipient of a distribution may have to make estimated tax payments. For more information, see *Withholding Tax and Estimated Tax* in Publication 575.

Tax on Premature (Early) Distributions

If a distribution is made to an employee under the plan before he or she reaches age 59½, the employee may have to pay a ***10%*** additional tax on the premature distribution. This tax applies to the amount received that the employee must include in income.

Exceptions. The 10% tax will not apply if distributions before age 59½ are:

- Made to a beneficiary (or to the estate of the employee) on or after the ***death*** of the employee.
- Due to the employee having a qualifying ***disability.***
- Part of a series of substantially equal ***periodic payments*** beginning after separation from service and made at least annually for the life or life expectancy of the employee or the joint lives or life expectancies of the employee and his or her designated beneficiary. (The payments under this exception, except in the case of death or disability, must continue for at least 5 years or until the employee reaches age 59½, whichever is the longer period.)
- Made to an employee after ***separation*** from service if the separation occurred during or after the calendar year in which the employee reached age 55.
- Made to an alternate payee under a ***qualified domestic relations order (QDRO).***
- Made to an employee for ***medical care*** up to the amount allowable as a medical expense deduction (determined without regard to whether the employee itemizes deductions).
- Timely made to reduce ***excess contributions*** under a 401(k) plan.
- Timely made to reduce excess employee or matching employer contributions ***(excess aggregate contributions.)***
- Timely made to reduce ***excess elective deferrals***.

Reporting the tax. To report this tax on early distributions, file Form 5329. See the form instructions for additional information about this tax.

Tax on Excess Benefits

If you are or have been a ***5% owner*** of the business maintaining the plan, amounts you receive at any age that exceed the benefits provided for you under the plan formula are subject to an additional tax. This tax also applies to amounts received by your successor. The tax is 10% of the excess benefit that is includible in income.

Lump-sum distributions. The amount subject to the additional tax is not eligible for the optional methods of figuring income tax on a lump-sum distribution. The optional methods are discussed under *Lump-Sum Distributions* in Publication 575.

5% owner. For purposes of this tax, you are a 5% owner if you own more than 5% of the capital or profits interest in the employer. You are also a 5% owner if you were a 5% owner at any time during the 5 plan years immediately before the plan year that ends within the tax year in which you receive the distribution.

Reporting the tax. Include on Form 1040, line 53, any tax you owe for an excess benefit. On the dotted line next to the total, write "Section 72(m)(5)" and write in the amount.

Excise Tax on Reversion of Plan Assets

A 20% or 50% excise tax generally is imposed on any direct or indirect reversion of qualified plan assets to an employer. If you owe this tax, report it in Part XIII of Form 5330. See the Form 5330 instructions for more information.

Prohibited Transactions

Certain transactions (listed below) between the plan and a ***disqualified person*** generally are prohibited. (However, see *Exemptions,* later.) A 10% excise tax is charged on these transactions if they took place after August 20, 1996 and before August 6, 1997. If you are a disqualified person who takes part in a prohibited transaction, you must pay the tax.

*Any prohibited transaction that takes place **after August 5, 1997,** is subject to a higher excise tax of 15% on the "amount involved." See* Tax on Prohibited Transactions, *later.*

Disqualified person. You are a disqualified person if you are:

1) An employer of any participants in the plan,
2) A 10% (or more) partner in a partnership having the plan,
3) A fiduciary of the plan,
4) A highly compensated employee (earning 10% or more of the employer's yearly wages),
5) An employee organization, any of whose members are covered by the plan, or
6) A person providing services to the plan.

Related disqualified persons. If you are a disqualified person, the following are also disqualified persons:

1) Members of your family (spouse, ancestors, direct descendants, and any spouse of a direct descendant),
2) Corporations, partnerships, trusts, or estates in which you own, directly or indirectly, at least half the:
   a) Total voting stock or the value of all stock of the corporation,
   b) Capital interest or profit interest of the partnership, or
   c) Beneficial interest of the trust or estate.

Prohibited transactions generally include:

1) A transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person;
2) Dealing with plan income or assets by a fiduciary in his or her own interest;
3) The receiving of consideration by a fiduciary for his or her own account from a party that is dealing with the plan in a transaction that involves plan income or assets; or
4) Any of the following acts between the plan and a disqualified person:
   a) Selling, exchanging, or leasing property,
   b) Lending money, extending credit, or
   c) Furnishing goods, services, or facilities.

Loans to owner-employee. A loan from a Keogh plan to a self-employed individual also may be a ***prohibited transaction***.

Exemptions. A prohibited transaction does not take place if you are a disqualified person and receive any benefit to which you are entitled as a plan participant or beneficiary. However, the benefit must be figured and paid under the same terms as for all other participants and beneficiaries.

Other transactions also are exempt from being treated as prohibited transactions. See

section 4975 of the Internal Revenue Code and its underlying regulations.

Tax on Prohibited Transactions

Initial tax. The tax on a prohibited transaction is *10%* of the *amount involved* for each year (or part of a year) in the taxable period. If it takes place after August 5, 1997, the tax is 15%.

100% additional tax. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed. Both taxes are payable by any disqualified person who participated in the transaction (other than a fiduciary acting only as such). If more than one person takes part in the transaction, each person can be jointly and severally liable for the entire tax.

Amount involved. The amount involved in a prohibited transaction is the greater of:

- The money and fair market value of any property given, or
- The money and fair market value of any property received.

Services. If services are performed, the amount involved is any excess compensation given or received.

Taxable period. The taxable period starts on the transaction date and ends on the earliest of the following:

- The day IRS mails a notice of deficiency for the tax,
- The day IRS assesses the tax, or
- The day the correction of the transaction is completed.

Payment of the 10% tax. Pay the 10% tax (15% after August 5, 1997) with Form 5330.

Correcting prohibited transactions. If you are a disqualified person who participated in a prohibited transaction, you can minimize the tax by correcting it as soon as possible. Correcting it means undoing it as much as you can without putting the plan in a worse financial position than if you had acted under the highest fiduciary standards.

100% tax for failure to correct. The 100% tax is charged if you do not correct the transaction during the taxable period. It is based on the amount involved that is figured by using the highest fair market value during the taxable period of any property given or received in the transaction.

Correction period. If the prohibited transaction is not corrected during the taxable period, you usually have an additional 90 days after the day the IRS mails a notice of deficiency for the 100% tax to correct the transaction. This correction period (the taxable period plus the 90 days) can be extended if:

- IRS grants a reasonable time needed to correct the transaction, or
- You petition the Tax Court.

If you correct the transaction within this period, IRS will abate, credit, or refund the 100% tax.

Reporting Requirements

As the Keogh plan administrator or the employer, you may have to file an annual return/report form by the last day of the 7th month after the plan year ends. See the following list of forms to choose the right form for your plan.

Form 5500–EZ. You can use Form 5500–EZ if you meet ***ALL*** of the following conditions.

1) The plan is a one-participant plan.
2) The plan meets the minimum coverage requirements of Section 410(b) of the Internal Revenue Code without being combined with any other plan you may have that covers other employees of your business.
3) The plan does not provide benefits for anyone except you, or you and your spouse, or one or more partners and their spouses.
4) The plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control.
5) The plan does not cover a business that leases employees.

Your plan is a one-participant plan if as of the first day of the plan year for which the form is filed, either:

1) The plan covers only you (or you and your spouse) and you (or you and your spouse) own the entire business. (The business may be incorporated or unincorporated.), or
2) The plan covers only one or more partners (or partner(s) and spouse(s)) in a business partnership.

See the filled-in copy of Form 5500–EZ near the end of this publication.

You do not have to file Form 5500–EZ (or Forms 5500 or 5500–C/R), ***if*** you meet the conditions mentioned above, ***and***

1) You have a one-participant plan that had total plan assets of $100,000 or less at the end of every plan year ending after January 1, 1994, ***or***
2) You have two or more one-participant plans that together had total plan assets of $100,000 or less at the end of every plan year ending after January 1, 1994.

However, all one-participant plans must file a Form 5500–EZ for their final plan year, even if the total plan assets have always been less than $100,000. The final plan year is the year in which distribution of all plan assets is completed.

Form 5500–C/R. Unless otherwise exempted, file Form 5500–C/R if your plan has fewer than 100 participants at the start of the plan year, or if your one-participant plan does not meet the conditions outlined in the instructions for Form 5500–EZ.

Form 5500. If your plan has 100 or more participants at the start of the plan year, you must file Form 5500.

Schedule A (Form 5500). If any plan benefits are provided by an insurance company, insurance service, or similar organization, complete and attach Schedule A (Form 5500), *Insurance Information* to Form 5500 or Form 5500–C/R. Schedule A is not needed for a plan that covers only:

1) An individual or an individual and spouse who wholly own the trade or business, whether incorporated or unincorporated, or
2) Partners in a partnership or the partners and their spouses.

Do not file a Schedule A (Form 5500) with a Form 5500–EZ.

Schedule B (Form 5500). For most defined benefit plans, complete and attach Schedule B (Form 5500), *Actuarial Information,* to Form 5500, Form 5500–C/R, or Form 5500–EZ.

Schedule P (Form 5500), *Annual Return of Fiduciary of Employee Benefit Trust,* is used by a fiduciary (trustee or custodian) of a trust described in section 401(a) of the Internal Revenue Code or a custodial account described in section 401(f) to protect it under the statute of limitations provided in section 6501(a). The filing of a completed Schedule P by the fiduciary satisfies the annual filing requirement, under section 6033(a), for the trust or custodial account created as part of a Keogh plan. This filing starts the running of the 3–year limitation period that applies to the trust or custodial account. For this protection, the trust or custodial account must qualify under section 401(a) and be exempt from tax under section 501(a). The fiduciary should file, under section 6033(a), a Schedule P as an attachment to Form 5500, 5500–C/R, or Form 5500–EZ for the plan year in which the trust year ends. The fiduciary cannot file Schedule P separately. Refer to the Schedule P instructions for more information.

Form 5310. If you terminate your plan and are the plan sponsor or plan administrator, you can file Form 5310, *Application for Determination for Terminating Plan.* Your application must be accompanied by the appropriate user fee and Form 8717, *User Fee for Employee Plan Determination Letter Request.*

More information. For more information about reporting requirements, see the forms and their instructions.

Keogh Plan Qualification Rules

To qualify for the tax benefits available to qualified plans, a Keogh plan must meet certain requirements (qualification rules) of the tax law. Generally, unless you write your own plan, the financial institution that provided your plan will take the continuing responsibility for meeting qualification requirements that are later changed. The following is a brief overview of important qualification rules that generally have not yet been discussed. It is not intended to be all-inclusive. See *Setting Up a Keogh Plan,* earlier.

TIP *Generally, the following qualification rules also apply to a SIMPLE 401(k) retirement plan. A SIMPLE 401(k) plan is, however, not subject to the top-heavy rules and nondiscrimination rules of qualified plans if the plan satisfies the provisions discussed earlier under* SIMPLE 401(k) Plan.

Plan assets must not be diverted. Your plan must make it impossible for its assets to be used for, or diverted to, purposes other than for the benefit of employees and their beneficiaries. As a general rule the assets cannot be diverted to the employer.

Minimum coverage requirements must be met. To be a qualified plan, a defined benefit plan must benefit at least the lesser of:

1) 50 employees, or
2) The greater of:
   a) 40% of all employees, or
   b) Two employees.

If there is only one employee, the plan must benefit that employee.

Contributions or benefits must not discriminate. Under the plan, contributions or benefits to be provided must not discriminate in favor of highly compensated employees.

Contribution and benefit limits must not be exceeded. Your plan must not provide for contributions or benefits that exceed certain limits. The limits apply to the annual contributions and other additions to the account of a participant in a defined contribution plan and to the annual benefit payable to a participant in a benefit plan. These limits were discussed earlier under *Contributions.*

Minimum vesting standards must be met. Your plan must satisfy certain requirements regarding when benefits vest. A benefit is ***vested*** (you have a fixed right to it) when it becomes nonforfeitable. A benefit is ***nonforfeitable*** if it cannot be lost upon the happening, or failure to happen, of any event.

Leased employees. A leased employee, defined below, who performs services for any person (recipient of the services) is treated as an employee of the recipient of the services for certain plan qualification requirements. These requirements include:

1) Nondiscrimination in coverage, contributions, and benefits,
2) Minimum age and service requirements,
3) Vesting,
4) Limits on contributions and benefits, and
5) Top-heavy plan requirements.

However, contributions or benefits provided by the leasing organization for services performed for the recipient of the services are treated as provided by the recipient.

Leased employee defined. A leased employee is a person who is ***not*** the common-law employee of a recipient and who:

1) Provides services to the recipient under an agreement between the recipient and a leasing organization,
2) Has performed services for the recipient (or for the recipient and related persons) substantially full time for at least 1 year, and
3) Performs services under the primary direction or control of the recipient.

Safe harbor exception. A leased employee is not treated as the employee of the recipient of the services if the employee is covered by the leasing organization under its qualified pension plan and leased employees are not more than 20% of the recipient's nonhighly compensated work force. The leasing organization's plan must be a money purchase pension plan providing:

- Immediate participation,
- Full and immediate vesting, and
- A nonintegrated employer contribution rate of at least 10% of compensation for each participant.

However, if the leased employee is considered a common-law employee of the recipient, that employee will be the recipient's employee for all purposes, regardless of any pension plan of the leasing organization.

Benefit payments must begin when required. Your plan must provide that, unless the participant chooses otherwise, the payment of benefits to the participant must begin within 60 days after the close of the ***latest*** of:

1) The plan year in which the participant reaches the earlier of age 65 or the normal retirement age specified in the plan,
2) The plan year in which the 10th anniversary of the year in which the participant came under the plan occurs, or
3) The plan year in which the participant separated from service.

Early retirement. Your plan can provide for payment of retirement benefits before the normal retirement age. If your plan offers an early retirement benefit, a participant who separates from service before satisfying the early retirement *age requirement* becomes entitled to that benefit if he or she:

- Satisfied the ***service requirement*** for the early retirement benefit, and
- Separated from service with a nonforfeitable right to an accrued benefit. The benefit, which may be actuarially reduced, is payable when the early retirement age requirement is met.

Survivor benefits. Defined benefit and certain money purchase pension plans must provide automatic survivor benefits in the form of:

1) A qualified joint and survivor annuity for a vested participant who does not die before the annuity starting date.
2) A qualified pre-retirement survivor annuity for a vested participant who dies before the annuity starting date and who has a surviving spouse.

The automatic survivor benefit also applies to any participant under a profit-sharing plan unless:

1) The participant does not choose benefits in the form of a life annuity,
2) The plan pays the full vested account balance to the participant's surviving spouse (or other beneficiary if the surviving spouse consents or if there is no surviving spouse) if the participant dies, and
3) The plan is not a direct or indirect transferee of a plan that must provide automatic survivor benefits.

Loan secured by benefits. If survivor benefits are required for a spouse under a plan, he or she must consent to a loan that uses as security the accrued benefits in the plan.

Waiver of survivor benefits. Each plan participant may be permitted to waive the joint and survivor annuity or the preretirement survivor annuity (or both); but only if the participant has the written consent of the spouse. The plan also must allow the participant to withdraw the waiver. The spouse's consent must be witnessed by a plan representative or notary public.

Waiver of 30–day waiting period before annuity starting date. For plan years beginning after 1996, a plan may permit a participant to waive (with spousal consent) the 30–day minimum waiting period after a written explanation of the terms and conditions of a joint and survivor annuity is provided to each participant.

The waiver is allowed only if the distribution commences more than 7 days after the written explanation is provided.

Involuntary cash-out of benefits not more than dollar limit. A plan may provide for the immediate distribution of the participant's benefit under the plan if the value of the benefit is not greater than $3,500 for plan years beginning before August 6, 1997. For plan years beginning after August 5, 1997, the involuntary cash-out limit that applies is $5,000.

However, the distribution cannot be made after the annuity starting date unless the participant and the spouse (or surviving spouse of a participant who died) consent in writing to the distribution. If the present value is greater than the dollar limit that applies, the plan must have the written consent of the participant and spouse (or surviving spouse) for any immediate distribution of the benefit.

Consolidation, merger, or transfer of assets or liabilities. Your plan must provide that, in the case of any merger or consolidation with, or transfer of assets or liabilities to, any other plan, each participant would (if the plan then terminated) receive a benefit equal to or more than the benefit he or she would have been entitled to just before the merger, etc. (if the plan had then terminated).

Benefits must not be assigned or alienated. Your plan must provide that its benefits cannot be assigned or alienated.

Exception for certain loans. A loan from the plan (not from a third party) to a participant or beneficiary is not treated as an assignment or alienation if the loan is secured by the participant's accrued nonforfeitable benefit and is exempt from the tax on prohibited transactions or would have been exempt if the participant were a disqualified person.

Exception for domestic relations orders. Compliance with a judgment, decree, or order relating to child support, alimony payments, or marital property rights under a state domestic relations law that meets certain requirements (a qualified domestic relations order) does not result in a prohibited assignment or alienation of benefits.

Payments to an alternate payee under a qualified domestic relations order before the

participant attains age 59½ are not subject to the 10% additional tax that would otherwise apply under certain circumstances. The interest of the alternate payee is not taken into account in determining whether a distribution to the participant is a lump-sum distribution. Benefits distributed to an alternate payee under a qualified domestic relations order can be rolled over tax free to an individual retirement account or to an individual retirement annuity.

There must be no benefit reduction for social security increases. Your plan must not permit a benefit reduction for a post-separation increase in the social security benefit level or wage base for any participant or beneficiary who is receiving benefits under your plan, or who is separated from service and has nonforfeitable rights to benefits. This rule also applies to plans supplementing the benefits provided by other federal or state laws.

Elective deferrals must be limited. If your plan provides for elective deferrals, it must limit those deferrals to the amount in effect for that particular year. See *Limit on Elective Deferrals,* earlier.

Top-heavy plan requirements. A top-heavy plan is one that mainly favors partners, self-employed persons, and other key employees.

A plan is top heavy for any plan year for which the total value of accrued benefits or account balances of key employees is more than 60% of the total value of accrued benefits or account balances of all employees. Additional requirements apply to a top-heavy plan primarily to provide minimum benefits or contributions for nonkey employees covered by the plan.

Most qualified plans, whether or not top-heavy, must contain provisions that meet the top-heavy requirements and that will take effect in plan years in which the plans are top heavy. These qualification requirements for top-heavy plans are set forth in Internal Revenue Code section 416 and its underlying regulations.

SIMPLE exception. The top-heavy plan requirements do not apply to SIMPLE plans.

Form 5500–EZ Example

John Jones is in business for himself as the J & J Repair Service. He provides radio and television repair service. His wife, Beth, also works in the business. He has no other employees. The business has a Keogh money purchase pension plan adopted in 1987 with an effective date of January 1, 1987. This is John's only pension plan.

Contributions to the pension plan for 1997 were $20,000. The income earned by the plan for 1997 was $10,000. The bank charged John's plan a $100 maintenance fee for 1997. The total assets of the plan at the end of 1997 were $108,490.

John completes and files Form 5500–EZ for 1997 as shown in the example of a filled-in Form 5500–EZ on the next page.

Form **5500-EZ**

Department of the Treasury
Internal Revenue Service

Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan

This form is required to be filed under section 6058(a) of the Internal Revenue Code.

► See separate instructions.

OMB No. 1545-0956

1997

This Form Is Open to Public Inspection

Please type or print

For the calendar plan year 1997 or fiscal plan year beginning , 1997, and ending , 19

This return is: (i) ☐ the first return filed (ii) ☐ an amended return (iii) ☐ the final return (iv) ☐ a short plan year (less than 12 mos.)

Check here if you filed an extension of time to file and attach a copy of the approved extension . . . . ► ☐

Use IRS label. Otherwise, please type or print.

1a Name of employer
John Jones DBA J&J Repair Service

Number, street, and room or suite no. (If a P.O. box, see instructions for line 1a.)
1234 Second Street

City or town, state, and ZIP code
Anytown, VA 22000

1b **Employer identification number**
00 ⁞ 1234567

1c Telephone number of employer
(518) 999-1234

1d Business activity code
7622

1e If plan year has changed since last return, check here . . . . ► ☐

2a Is the employer also the plan administrator? ☒ Yes ☐ No (If "No," see instructions.)

2b (i) Name of plan ► J&J Repair Service Pension Plan

(ii) ☐ Check if name of plan has changed since last return

2c Date plan first became effective
Month 01 Day 01 Year 87

2d Enter three-digit plan number ► 0 0 1

3 Type of plan: **a** ☐ Defined benefit pension plan (attach Schedule B (Form 5500)) **b** ☒ Money purchase pension plan (see instructions)
c ☐ Profit-sharing plan **d** ☐ Stock bonus plan **e** ☐ ESOP plan (attach Schedule E (Form 5500))

4a If this is a master/prototype, or regional prototype plan, enter the opinion/notification letter number . .

b Check if this plan covers: (i) ☒ Self-employed individuals, (ii) ☐ Partner(s) in a partnership, or (iii) ☐ 100% owner of corporation

5a Enter the number of qualified pension benefit plans maintained by the employer (including this plan). . . ► 1

b Check here if you have more than one plan and the total assets of all plans are more than $100,000 (see instructions) . . . . . ► ☐

		Line	Number
6	Enter the number of participants in each category listed below:		
a	Under age 59½ at the end of the plan year	**6a**	2
b	Age 59½ or older at the end of the plan year, but under age 70½ at the beginning of the plan year	**6b**	0
c	Age 70½ or older at the beginning of the plan year	**6c**	0

7a (i) Is this a fully insured pension plan which is funded entirely by insurance or annuity contracts? . . ► ☐ Yes ☒ No
If "Yes," complete lines 7a(ii) through 7f and skip lines 7g through 9d.

(ii) If 7a(i) is "Yes," are the insurance contracts held: . . . . . ► ☐ under a trust ☐ with no trust

		Line	Amount
b	Cash contributions received by the plan for this plan year	**7b**	20,000
c	Noncash contributions received by the plan for this plan year	**7c**	0
d	Total plan distributions to participants or beneficiaries	**7d**	0
e	Total nontaxable plan distributions to participants or beneficiaries	**7e**	0
f	Transfers to other plans	**7f**	0
g	Amounts received by the plan other than from contributions	**7g**	10,000
h	Plan expenses other than distributions	**7h**	100
8a	Total plan assets at the end of the year	**8a**	108,490
b	Total plan liabilities at the end of the year	**8b**	0

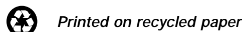
	Check "Yes" and enter amount involved if any of the following transactions took place between the plan and a disqualified person during this plan year. Otherwise, check "No."		Yes	No	Amount
9a	Sale, exchange, or lease of property	**9a**		X	
b	Payment by the plan for services	**9b**		X	
c	Acquisition or holding of employer securities	**9c**		X	
d	Loan or extension of credit	**9d**		X	

	If 10a is "No," do not complete line 10b and line 10c. See the specific instructions for line 10b and line 10c.		Yes	No
10a	Does your business have any employees other than you and your spouse (and your partners and their spouses)? ►	**10a**		X
b	Total number of employees (including you and your spouse and your partners and their spouses) ►			
c	Does this plan meet the coverage requirements of Code section 410(b)? ►	**10c**		
11a	Did the plan distribute any annuity contracts this plan year? ►	**11a**		X
b	During this plan year, did the plan make distributions to a married participant in a form other than a qualified joint and survivor annuity or were any distributions on account of the death of a married participant made to beneficiaries other than the spouse of that participant? ►	**11b**		X
c	During this plan year, did the plan make loans to married participants? ►	**11c**		X

Under penalties of perjury and other penalties set forth in the instructions, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of employer (owner) or plan administrator ► John Jones Date ► 7/20/98

For Paperwork Reduction Act Notice, see the instructions to Form 5500-EZ. Cat. No. 63263R Form **5500-EZ** (1997)



Printed on recycled paper

How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 with your tax questions or to order forms and publications. See your income tax package for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Glossary

The definitions in this glossary are the meanings of the terms as used in this publication. The same term used in another publication may have a slightly different meaning.

Annual addition. The annual addition is the total in a year of all employer contributions, employee contributions (not including rollovers), and forfeitures allocated to a participant's account.

Annual benefit. The annual benefit is a benefit to be paid yearly in the form of a straight-life annuity (with no extra benefits) under a plan but excluding the benefit attributable to employee contributions or rollover contributions.

Business. A business is an activity in which profit motive is present and some type of economic activity is involved. Service as a newspaper carrier under age 18 is not a business, but service as a newspaper dealer is. Service as a sharecropper under an owner-tenant arrangement is a business. Service as a public official is not.

Common-law employee. A common-law employee is a person who performs services for an employer who has the right to control and direct both the results of the work and the way in which it is done. For example, the employer:

- Provides the employee's tools, materials, and workplace, and
- Can fire the employee.

For Keogh plan purposes, common-law employees are not self-employed with respect to income from their work, even if that income is self-employment income for social security tax purposes. For example, common-law employees who are ministers, members of religious orders, full-time insurance salespeople, and U.S. citizens employed in the United States by foreign governments cannot establish Keogh plans with respect to their earnings from those employments, even though their earnings are treated as self-employment income.

However, a common-law employee can be self-employed as well. For example, an attorney can be a corporate common-law employee during regular working hours and also practice law in the evening as a self-employed person. In another example, a minister employed by a congregation for a salary is a common-law employee even though the salary is treated as self-employment income for social security tax purposes. However, fees reported on Schedule C (Form 1040) for performing marriages, baptisms, and other personal services are self-employment earnings for Keogh plan purposes.

Compensation. Compensation means the pay a participant received from an employer for personal services for a year. An employer can generally define compensation as including:

1) Wages and salaries,
2) Fees for professional services, and
3) Other amounts received (cash or noncash) for personal services actually rendered by an employee, including, but not limited to:
   a) Commissions and tips,
   b) Fringe benefits, and
   c) Bonuses.

The definition of compensation generally cannot include:

- Reimbursements or other expense allowances (unless paid under a nonaccountable plan), or
- Deferred compensation (either amounts going in or amounts coming out), unless the employer elects to treat certain elective deferrals as compensation for purposes of plan qualification (but not for purposes of determining maximum deductible amounts).

Note. For years beginning after 1997, compensation for purposes of determining maximum contribution amounts includes certain elective deferrals.

Other options. In figuring the compensation of a common-law employee, you can treat one of the following as the employee's compensation.

1) The employee's wages as defined for income tax withholding purposes, or
2) The employee's wages that you report in box 1 of Form W–2, *Wage and Tax Statement,* or
3) The employee's social security wages (including elective deferrals).

Self-employed person. For a self-employed person, compensation means the ***earned income*** (as discussed later) of the person.

Contribution. A contribution is an amount an employer pays into a plan for all those (including the self-employed) participating in the plan. Limits apply to how much, under the contribution formula of the plan, can be contributed each year for a participant.

Deduction. A deduction is the amount of plan contributions an employer takes on an income tax return as a subtraction from gross income. Limits apply to the amount deductible.

Earned income. Earned income for Keogh plan purposes is net earnings from self-employment (defined below) from a business in which your services materially helped to produce the income.

You can have earned income from property that your personal efforts helped create, such as books or inventions on which you earn royalties. Earned income includes net earnings from selling or otherwise disposing of the property, but it does not include capital gains. It includes income from licensing the use of property other than goodwill.

Earned income does not include interest income.

If you have more than one business, but only one has a retirement plan, only the earned income from that business is considered for that plan.

Employee. For retirement plan purposes, the term “employee” generally includes a self-employed person as well as a common-law employee. It also may include a leased employee.

Employer. A sole proprietor is his or her own employer for Keogh plan purposes, and a partnership employs each partner. A partner is not an employer for Keogh plan purposes.

Fishermen treated as self-employed. Certain fishermen may be considered self-employed for purposes of setting up a Keogh plan. See Publication 595, *Tax Highlights for Commercial Fishermen,* for the special rules that apply.

Master plan. A master plan has a single trust or custodial account. If you adopt a master plan, you use the single trust or custodial account along with the other employers adopting the plan.

Net earnings from self-employment. For SEP and Keogh plan purposes, these earnings are a self-employed person's gross income from a business, taking into account allowable deductions for that business. Allowable deductions include contributions to SEP and Keogh plans for common-law employees. Earnings from self-employment do not include items that are excluded from gross income (or their related deductions) other than foreign earned income and foreign housing cost amounts. For the deduction limits, earned income is net earnings for personal services actually rendered to the business. You take into account the income tax deduction allowed for one-half of the self-employment tax and the deduction for contributions to a qualified plan made on your behalf when figuring net earnings. Net earnings include a partner's distributive share of partnership income or loss (other than separately stated items, such as capital gains and losses). It does not include income passed through to shareholders of S corporations. ***Guaranteed payments to limited partners*** qualify as net earnings from self-employment if they are paid for services to or for the partnership. Distributions of other income or loss to limited partners do not qualify.

Partner. An individual who shares ownership of an unincorporated trade or business with one or more persons.

Prototype plan. This is a plan with separate trusts or custodial accounts for each employer who adopts the plan.

Self-employed individual. An individual in business for himself or herself is self-employed. Sole proprietors and partners are self-employed. Self-employment can include part-time work.

Not everyone who has net earnings from self-employment for social security tax purposes is self-employed for Keogh plan purposes. See *Common-law employee,* earlier. Also see *Net earnings from self-employment.*

Sole proprietor. An individual in business for himself or herself and who is the only owner of the unincorporated trade or business.

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17 Your Federal Income Tax (For Individuals)
225 Farmer's Tax Guide
334 Tax Guide for Small Business
509 Tax Calendars for 1998
553 Highlights of 1997 Tax Changes
595 Tax Highlights for Commercial Fishermen
910 Guide to Free Tax Services

Employer's Guides

15 Employer's Tax Guide (Circular E)
15-A Employer's Supplemental Tax Guide
51 Agricultural Employer's Tax Guide (Circular A)
80 Federal Tax Guide For Employers in the Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
179 Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
926 Household Employer's Tax Guide

Specialized Publications

378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
505 Tax Withholding and Estimated Tax
510 Excise Taxes for 1998
515 Withholding of Tax on Nonresident Aliens and Foreign Corporations
517 Social Security and Other Information for Members of the Clergy and Religious Workers
527 Residential Rental Property
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987
535 Business Expenses
536 Net Operating Losses
537 Installment Sales
538 Accounting Periods and Methods
541 Partnerships
542 Corporations
544 Sales and Other Dispositions of Assets
551 Basis of Assets
556 Examination of Returns, Appeal Rights, and Claims for Refund
560 Retirement Plans for Small Business (SEP, Keogh, and SIMPLE Plans)
561 Determining the Value of Donated Property
583 Starting a Business and Keeping Records
587 Business Use of Your Home (Including Use by Day-Care Providers)
594 Understanding the Collection Process
597 Information on the United States-Canada Income Tax Treaty
598 Tax on Unrelated Business Income of Exempt Organizations
686 Certification for Reduced Tax Rates in Tax Treaty Countries
901 U.S. Tax Treaties
908 Bankruptcy Tax Guide
911 Direct Sellers
925 Passive Activity and At-Risk Rules
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
953 International Tax Information for Businesses
1544 Reporting Cash Payments of Over $10,000
1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

W-2 Wage and Tax Statement
W-4 Employee's Withholding Allowance Certificate
940 Employer's Annual Federal Unemployment (FUTA) Tax Return
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return
1040 U.S. Individual Income Tax Return
- **Sch A** Itemized Deductions
- **Sch B** Interest and Dividend Income
- **Sch C** Profit or Loss From Business
- **Sch C-EZ** Net Profit From Business
- **Sch D** Capital Gains and Losses
- **Sch E** Supplemental Income and Loss
- **Sch F** Profit or Loss From Farming
- **Sch H** Household Employment Taxes
- **Sch R** Credit for the Elderly or the Disabled
- **Sch SE** Self-Employment Tax

1040-ES Estimated Tax for Individuals
1040X Amended U.S. Individual Income Tax Return
1065 U.S. Partnership Return of Income
- **Sch D** Capital Gains and Losses
- **Sch K-1** Partner's Share of Income, Credits, Deductions, etc.

1120 U.S. Corporation Income Tax Return
1120-A U.S. Corporation Short-Form Income Tax Return
1120S U.S. Income Tax Return for an S Corporation
- **Sch D** Capital Gains and Losses and Built-In Gains
- **Sch K-1** Shareholder's Share of Income, Credits, Deductions, etc.

2106 Employee Business Expenses
2106-EZ Unreimbursed Employee Business Expenses
2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts
2441 Child and Dependent Care Expenses
2848 Power of Attorney and Declaration of Representative
3800 General Business Credit
3903 Moving Expenses
4562 Depreciation and Amortization
4797 Sales of Business Property
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return
5329 Additional Taxes Attributable to Qualified Retirement Plans (Including IRAs), Annuities, and Modified Endowment Contracts
6252 Installment Sale Income
8283 Noncash Charitable Contributions
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business
8582 Passive Activity Loss Limitations
8606 Nondeductible IRAs (Contributions, Distributions, and Basis)
8822 Change of Address
8829 Expenses for Business Use of Your Home